The Manufacturers Hanover
Economic Report

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Triangulation

Long a preoccupation of the financial markets, Federal Reserve watching recently reached new heights (or maybe I should say, new lows). As if speculation over the weekly money supply figures was not enough, the markets since late October have become transfixed over the discount rate—on a daily basis. No doubt concerned over the surge in money growth since midyear, investors evidently were seeking reassurance in the form of further cuts in the discount rate that the Fed would continue "to attach much less than usual weight to movements in M1", as Federal Reserve Chairman Paul A. Volcker told the Business Council meeting last month in Hot Springs, Virginia.

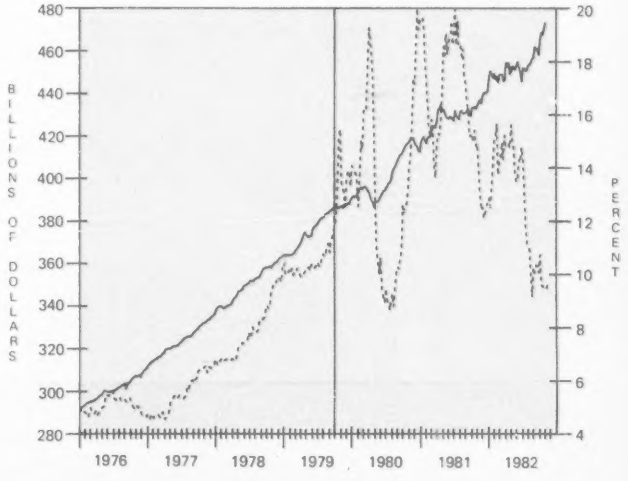
I can understand this, since to go back to strict monetarism at this time would mean that the Federal Reserve would have to drain a sizable amount of reserves from the banking system thereby pushing interest rates skyward. Since it was high interest rates that depressed the economy earlier this year, sending business failures and unemployment soaring to postwar highs and causing strains to develop in the financial system, the markets were sensitive to the possibility that rates might rise again while the economy remains weak.

In the final analysis, though, investors' main concern is for the state of the economy—as is that of the Federal Reserve, the Administration, businessmen and just about everyone else. As a result, they may have to accept the fact that changing economic and financial conditions may change the methods and objectives of Fed policy. In other words—because of the dramatic slowing of inflation, the changed monetary environment due to new regulations and increased sophistication, as well as the weakened state of the U.S. economy and our trading partners as well, it may not be as easy to track the Federal Reserve in the future as it was in the past. This is because the Federal Reserve may soon look at more than just money or interest rates, before making its decisions.

Monetarism Produced Side Effects . . .

A look at recent history provides some insight into why the Fed may find it useful to broaden its policy objectives. In late 1979 and early 1980, inflation was clearly the number one problem here in the U.S. and worldwide. The Fed became convinced that inflation in the longer run sense is a monetary phenomenon that can exist only when there is an excess amount of money in the economy relative to the amount of goods and services the system can generate. Accordingly, in October, 1979, the Fed changed tactics and began trying to control the money supply.

CHART I
MONEY SUPPLY – M1 (LINE) VS. FEDERAL FUNDS RATE (DOT) <WEEKLY FIGURES>



I am not so sure that precise control over the money supply was sought after by the Fed as much as providing the markets with a means of evaluating its policies. You see, the Fed had to establish credibility that it was going to bring down the rate of inflation because if it did not, inflation probably would have spiraled upward even faster. Since the money supply number was available weekly, it provided a convenient and timely guide, when plotted against the Federal Reserve's announced annual target ranges, to judge whether the Fed was doing what it said it would do.

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The policymaking process at last achieved sufficient discipline to convince people that the Fed would stay the course. Inflation moderated into single digits by mid-1981 and has continued to improve since. Consumer prices in 1982 very likely rose by only about five percent—the best annual performance since 1976.

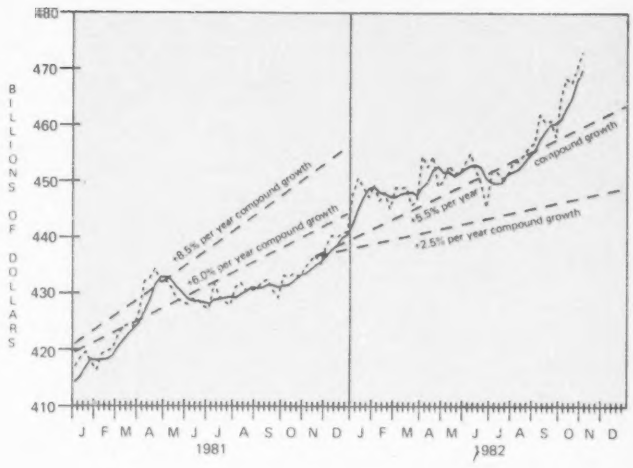
Even as it was succeeding in bringing down the rate of inflation, the Fed soon saw that its conversion to monetarism was producing some disturbing side effects. As was expected, interest rates became much more volatile day-to-day after October 6, 1979 than before. While this volatility dampened somewhat as the months went by, the gyrations were still large enough to cause money market participants to add a premium to the level of interest rates in order to compensate for this volatility. To make matters worse, the money supply seemed to fluctuate more after the Fed's policy switch than it did before (Chart I)! The net result was that interest rates did not come down as rapidly as inflation did, and real interest rates soared to the highest levels in half a century. In an effort to moderate these trends, the Fed tried on several occasions to shift the focus away from the weekly money supply figures. It was unsuccessful in each attempt, and interest rates held high, not dropping significantly until midyear 1982.

The sharp drop in interest rates which got underway in early July led to speculation that the Fed was easing. In actuality, the Fed had not changed its policy objectives at all, but rather, was following its previously articulated policy of trying to keep the money supply in the target range. It was the money supply dropping into the target range that led the markets, themselves, to relax and interest rates to begin falling. As the money supply continued to plunge the Fed began to inject reserves into the banking system in order to bring interest rates down to a level that would be consistent with some growth in the money supply once again. These developments took place amidst a backdrop of well-publicized strains in the financial system coming from a variety of sources.

. . . That Led To Hopes For A Change

It was these problems, along with the still-dismal prospects for the U.S. economy and those of its trading partners that caused participants in the financial markets to begin hoping that the Federal Reserve was going to shift gears. While remaining concerned about the money supply and inflation, the markets were beginning to worry more about interest rates and recession. Accordingly, they did not react adversely when continued injections of reserves into the banking system caused the money supply once again to go up over the target range. Indeed, as the view spread that the Fed had eased, it resulted in the most powerful stock market rally in history.

CHART II
MONEY SUPPLY, M1
FOUR-WEEK MOVING AVERAGE (LINE)
VS. WEEKLY FIGURES (DOT)



The jump in stock prices, as I indicated last month, did not occur because of any fundamental change in business conditions nor, obviously, because the Federal Reserve was keeping the growth of the money supply down. Rather, it occurred because of a belief on the part of investors that the Fed was once again looking at interest rates and as a result, was going to keep them down—if not push them lower. To be sure, this was not a widely held view outside of Wall Street. Fed officials took special pains to state that they had not changed the basic objectives of monetary policy, which were to control money growth and fight inflation. Various Fed watchers pointed out that over more than just a short period of time, the Fed cannot push rates lower even if it wanted to. They indicated a belief that the Fed was still fighting inflation and that this was the only "responsible" course for a central bank to take. Others, however, swore up and down that the Fed had eased monetary policy while still others came to the conclusion that the Fed was beginning to look at other objectives. To borrow some words from a famous user, monetary policy once again seemed to be "a riddle wrapped up in a mystery inside an enigma."

In recent months it has become clear that the economy's failure to grow over the past three years traces to the conflict that developed between monetary policy and fiscal policy when the Fed switched to monetarism. Fiscal policy, measured by Washington's budget deficits and associated borrowing requirements, was stimulative, while monetary policy was restrictive. Tight money succeeded in slowing inflation—but all that the loose fiscal policy did was to accentuate the effects of tight money by reducing even more the availability of funds for the private sector in order that Washington could satisfy its financial appetite.

If The Fed Monitors Several Indicators . . .

Bringing down the budget deficit will be extremely difficult as long as defense spending and the tax cut program are deemed sacrosanct. But if economic growth were to resume, the increased tax revenues might start the process going and make it easier for the Administration and Congress to compromise on other measures needed to slice the deficit. I think such growth might occur if the Federal Reserve were to broaden its monetary policy objectives. It seems to me that the Fed might be better able to establish conditions conducive to economic growth by looking at more than one indicator in the implementation of monetary policy. I suggest that it look at three: the money supply, prices and interest rates. In other words—the Fed should triangulate as it sets monetary policy.

Triangulation is nothing new. It is, of course, widely used in navigation, where several readings are taken at different points to determine the course that the vessel is on and whether it is the right one. Gunners in the artillery use this strategy to zero in on their target. Triangulation is also common in sporting events: Football games have several referees in order that the action can be better observed, as do other sports. And as any golfer will tell you, it is always easier to find the ball when there is a caddy down the fairway watching it from another perspective besides the view that the golfer gets from the tee.

As far as monetary policy is concerned, triangulation would seem to make a lot of sense. First of all, Paul Volcker, himself, has repeatedly expressed caution about the use of any single measure of money and credit, saying, "we have to be alert to the possibility that relationships may be disturbed by technological or regulatory changes in banking, or more broadly by shifts in liquidity preferences and velocity." He added last month: "in the circumstances, I do not believe that, in actual implementation of monetary policy, we have any alternative but to attach much less than usual weight to movements in M1 over the period immediately ahead."

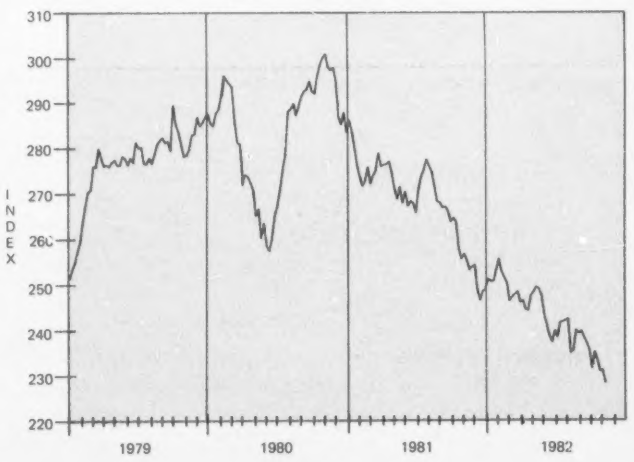
Chairman Volcker is very much concerned about restoring price stability. He believes that continued progress toward this objective is an essential part of building a solid base, "not just for recovery, but for sustaining expansion over a long period. Concern about inflation . . . is not something we can turn on and off; it will be a continuing priority concern of policy."

As for interest rates, Chairman Volcker's view is that lower interest rates are consistent with the needs for recovery. He feels, however, that the Fed cannot artificially force interest rates down. Rather, what is needed is market conviction that the fundamentals are consistent with lower interest rates: "over longer periods of time, achieving and maintaining the lower level of interest rates we would all like to see must, in a sense, be a reward for success in dealing with inflation . . ."

The above quotes are taken from Paul Volcker's speech to the Business Council last month. They suggest to me that the Federal Reserve may now be receptive to triangulating monetary policy. Such a policy would seem to be appropriate in today's environment. First of all, inflation may not be licked entirely but it is not the problem that it was three years ago. Accordingly, the Federal Reserve does not have to lock itself into the automatic pilot of M1 manipulation in order to establish its credibility as an inflation fighter.

Monetarism was the right policy three years ago, and even through most of 1981. However, it has become less and less useful—especially since the Fed undershot its 1981 growth targets and did not make allowances for this in establishing the position for the 1982 targets (Chart II). By midyear 1982, the Fed had worked itself into a corner that would not allow it to let interest rates fall. Since the money supply was growing above target throughout the first half of 1982, the markets began to conclude that interest rates were bound to stay high. If the Fed were to try to push rates down, the surge in money growth would result in higher interest rates. On the other hand, if the Fed were to turn back to looking at the money supply to the exclusion of everything else, interest rates would also rise. Either way, Fed actions (or inaction) could have worsened an already poor business climate. Thus the Fed seized upon the opportunity presented by the maturing all-saver accounts to downplay the M1 figure in early October.

CHART III
TUESDAY SPOT PRICE INDEX – ALL COMMODITIES
(1967=100)



The Fed can continue to throw up enough of a cloud of dust over the M1 figures to keep it from having to tighten until at least spring 1983. This is because the

upward distorting effects on M1 from the maturing all-savers accounts will soon be followed by downward distorting effects as the banks begin offering money market fund-type accounts which will be classified in M2. Then comes the new year and a new set of monetary growth targets.

If the past is any guide, the Fed will use as the base for its 1983 targets the average level of money for fourth-quarter 1982. This would position the new targets above the target bands for 1982—exactly the reverse of what happened between 1981 and 1982. Then, as you can see from Chart II, the Fed undershot its targets thereby positioning the 1982 targets well below the 1981 band, causing monetary policy to be unduly restrictive. But even 1983's higher bands might not be enough to match demand pressures for money, given the Federal government's prospective budget deficit. Hence, a return to money supply targeting alone will eventually lead to higher interest rates, which are bound to stifle the economy.

. . . It Will Help Growth Resume

In the interests of promoting real growth, the Fed ought to add two indicators to its policy objectives, besides money growth. For there are times when the needs of the economy dictate more money even though the money supply may already seem to be growing too rapidly. For example, the swift deceleration of consumer price inflation in the U.S., along with the actual plunge in commodities' prices worldwide, suggests that the Fed may have been a bit too zealous in slowing monetary growth. Of course, whether it would have been able to slow inflation at all had it taken a more gradual approach remains open to conjecture. The point is that commodities prices are still falling (Chart III) and this may be indicative of the need for more money to be pumped into the system by our central bank—and by other central banks as well.

Some would have the Fed look at the value of the dollar in conducting monetary policy. I do not think the relative strength or weakness of the dollar in of itself is something that the Fed should be all that concerned about. It could very well be that the dollar might be strong relative to other currencies even under a period of rapid inflation in the U.S. because inflation elsewhere is worse. If the Fed were to take this to mean that it should conduct an easier monetary policy, it would only worsen our inflation and probably cause inflation elsewhere to worsen as well.

I think the third leg of the triangle that the Fed should use in charting the course of real growth for the U.S. economy is interest rates. To be sure, I am not suggesting that the Federal Reserve try to stabilize either nominal interest rates or real interest rates (interest rates minus inflation). Attempting to do both in an era of large budget deficits can only result in rapid money growth and a return to high rates of inflation. All I am saying is that the Fed should look at interest rates (particularly real interest rates) as part of a three-pronged effort to generate economic growth.

For example, as noted above, the rate of consumer price inflation has slowed while commodities' prices are actually declining. At the same time, the U.S. and many of its trading partners remain mired in recession. A glance at real interest rates shows that they are well above their historical norms (Economic Report—Oct., 1982). This suggests that they may be too high to allow growth to resume. A triangulating monetary policy would therefore call for more reserves to be injected into the financial system with the intent of lowering real interest rates enough so that growth can resume. As long as real interest rates remain positive (and slightly above historical norms), inflation should not flare up. If it does, the Fed, by watching the price indices, will know soon enough to take appropriate steps.

Conclusion

This exposition is not designed to provide the ultimate answer to our economic problems. For even a three-cornered monetary policy is not sufficient to counter the effects of a fiscal policy that is locked in the "full steam ahead" position. However, as I observed above, this might offer an opportunity to start the budget deficit on its long-needed downhill course by providing enough liquidity for the economy to grow, hence, generating additional tax revenues.

The alternatives to triangulation do not seem very bright. If the Federal Reserve goes back to watching the money supply only and the government continues to run large and growing budget deficits, then we will be in for more of the same in 1983 and 1984 that we experienced from 1979 through 1982. On the other hand, if the Fed is forced by Congressional fiat to target either interest rates alone or prices alone, as several bills now pending call for, the end result could be a new round of inflation even worse than that experienced in the late 1970s and early in 1980.

To paraphrase Winston Churchill, one could say that triangulation may be the worst policy devised by the wit of man—except for all the others. ■

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Questions

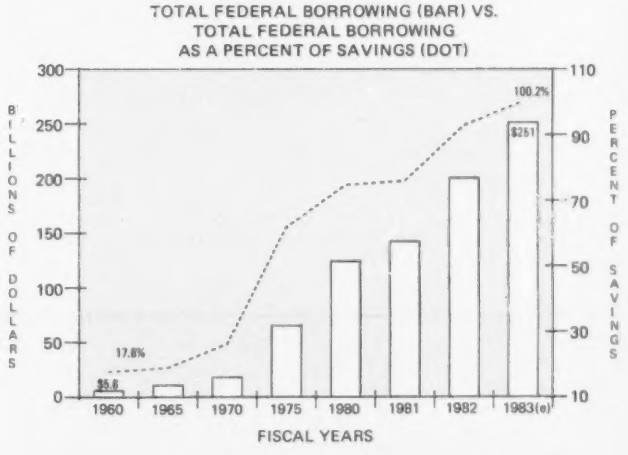
Nineteen hundred eighty-two will go down in the economic annals as the year of surprises. Not only did the U.S. economy fail to pick up the way most forecasters thought (and policymakers hoped), but it stayed down in the face of developments that in the past would have sent business soaring. Additionally, certain things happened that produced exactly the opposite effects compared with many economists' expectations. What follows is a list of questions chosen to illustrate the unusual developments that occurred in 1982 and my answers, which I hope will shed some light on 1982's performance and, in the process, indicate what ought to be done to improve business in 1983.

Why did the huge budget deficit posted in fiscal year 1982 fail to stimulate the U.S. economy?

This is a very reasonable question, since traditional Keynesian analysis suggests that when the Federal government runs a deficit in its budget, it is adding to aggregate demand in the economy. A big enough deficit, this reasoning goes, should be enough to offset whatever shortfall occurs in demand from the private sector. And indeed, this is exactly what happened once it was employed in the 1930s, although it took the huge spending associated with World War II to get us out of the Depression. But a budget deficit must be financed. And if the government's borrowing results in either less funds or costlier money available to the private sector, then its deficit will not only fail to stimulate the economy, it will make it weaker. The economy weakened in 1982 because, unlike the years 1933-40, when the money supply was growing at a 10 percent annual rate, the money supply barely grew at all between January and July 1982, and was only about four percent higher than the level reached 15 months earlier. As a result, the government's total borrowing needs in 1982 equalled over 90 percent of net national savings, compared with 75 percent in 1980 and 26 percent in 1970 (chart).

But interest rates were lower in 1982 than in 1981. Why did they fall in the face of rising budget deficits?

The decline in interest rates from their 1981 peaks should be viewed as a result of several sequential developments. The first dealt with the fact that the money supply during the last seven months of 1981 grew below the Federal Reserve's target ranges thereby easing market fears regarding future trends in Fed policy and inflation. Their declines in 1982 initially reflected the impact of a continued weakening of business activity, thus a slowing of the private sector's needs for funds. Later on, in the summer, rates were pushed down further by an easing of monetary policy. In other words —declines in interest rates over the past year and a half occurred because Washington's budget deficits crowded out the private sector, dampening economic activity, and not the reverse. They also reflected either changes in market psychology, in demands for money by the private sector or in the Fed's willingness to increase the supply of money.



A slow rate of money growth seems to result in lower interest rates while a faster rate of money growth seems to cause interest rates to go higher. Doesn't this violate the basic law of supply and demand?

It certainly does, but it is a by-product of the Federal Reserve's conversion to monetarism in October, 1979. Because the Fed announces its growth target objectives for the money supply each year, and because the money supply figures are available weekly, the markets

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are able to keep very close watch over the Fed's money market activities. And as a consequence of the widely held belief that too much money causes inflation, the markets will bid up interest rates when they see the money supply growing rapidly because they fear that it will result in either higher rates of inflation, which leads to higher interest rates longer term, or a tightening up on the part of the Fed, which also causes higher interest rates—in this instance, relatively sooner. Conversely, when the money supply grows more slowly, the markets will mark down interest rates, anticipating either less inflation or a loosening of Fed policy—both of which would tend to produce lower interest rates.

Well if that's the case, then how come the Federal Reserve has been able to increase the money supply at a 20 percent annual rate since mid-summer, pushing it far above its annual target bands for 1982, and yet interest rates fell?

Because the Federal Reserve has managed to convince the markets to overlook this, claiming that the validity of the money supply figures has been distorted by "technological or regulatory changes in banking, or more broadly by shifts in liquidity preferences and velocity." What this means is that the unusual severity of the recession may have changed people's attitudes toward holding money balances and that the Fed believes that it would not be inflationary to produce money at a faster rate of speed since people are not spending it as fast as they used to. In addition, there is a possibility that the maturing All-Savers Certificates, along with the new money market interest rate accounts that banks can now offer, are further distorting the money figures. Finally, as I observed two months ago, the money supply has not expanded all that rapidly, when viewed over a two-year period.

Then why have lower interest rates not revived economic activity?

First of all, interest rates have fallen at a slower pace this time, compared with previous cycles. Secondly, interest rates may be down in nominal or quoted terms, but they are still historically high when compared with inflation. Indeed, during the 1973-75 recession as well as the brief downturn of 1980, real interest rates were negative—that is, they were below the 12 month rate of inflation prevailing at those times. Those levels of interest rates provided great incentives for people to borrow in order to buy new cars, houses and other major items. It was also an inducement for business to borrow in order to build inventories and increase its capacity to produce. Conversely, high real interest rates are a deterrent to spending because the ability to obtain a rate of return above the inflation rate is a powerful incentive to save. High real interest rates are a deterrent to borrowing, since, in the case of business, these costs can neither be absorbed nor passed along. By the way, high real interest rates depressed the economy in 1982 in another way—by causing the dollar to be overvalued compared with foreign currencies thereby depressing exports and promoting imports.

FEDERAL BUDGET DEFICIT PROJECTIONS

($ billions; fiscal years)

	Date of Projections			
	Jul 81	Sep 81	Feb 82	Apr 82
Office of Management and Budget				
1982	– 42.5	– 43.1	– 98.6	–100.5
1983	– 22.9	– 22.9	– 91.5	–101.9
1984	+ 0.5	0.0	– 82.9	– 93.8
Congressional Budget Office				
1982	– 29.6	– 65.0	–109.0	–119.3
1983	+ 17.7	– 55.0	–157.0	–182.0
1984	+ 76.3	– 50.0	–188.0	–216.0

Why did interest rates not fall as quickly as the rate of inflation?

No one knows with any certainty, but it seems to me to trace to several recent developments. The greater volatility of both interest rates and the money supply following the Federal Reserve's shift to monetarism three years ago seems to have added a "volatility premium" to the level of interest rates besides the inflation and rent premiums, both of which had been embodied in interest rates for many years. In the summer of 1981, another premium might have been added, one that, for lack of a better term, could be called a "fear" premium. The markets got scared beginning in the summer of 1981 when Washington revealed that the government's budget deficits were not going to get smaller and eventually disappear by mid-decade, but rather, were going to get bigger and expand into the 12-digit territory (table). The fear was that either these deficits and their associated borrowing requirements would overwhelm the money and credit markets, driving up interest rates in the process—or that they would not; that the Federal Reserve would monetize these deficits, but in the process, set the stage for a new round of inflation.

Why was the money supply more volatile after October 1979 (when the Fed tried to control it) than before (when the Fed didn't)?

There are several reasons for this. The first deals with activities at the Federal Reserve's discount window. There have been times when the difference between the Federal funds rate (the rate banks charge each

other for overnight loans) and the Fed's discount rate (the rate that the Fed charges the banks when they borrow from it) has been quite large. The bigger this spread, the more some banks may have sought to meet their reserve requirements by borrowing from the Fed at lower costs than from another commercial bank. This spread tends to widen during periods when the Fed is trying to tighten monetary policy. Ironically, the tighter the Federal Reserve thinks monetary policy is getting as it pushes up money market interest rates, the easier policy may actually be, since the greater are member bank borrowings. Thus, notwithstanding whatever reductions in nonborrowed reserves the Fed may have aimed for in its open market operations, control over total reserves was less effective than it could have been because of the existence of this below-market discount rate, which the Fed calls an "escape valve." At any rate, the linkage between nonborrowed reserves and the money supply is not all that tight.

Another factor contributing to the volatility of money may have been the increased volatility of interest rates that developed in the wake of the Fed's switch to monetarism. It had been anticipated, of course, that interest rates would be more unstable once the Federal Reserve stopped paying much attention to controlling them, but the degree of volatility was far beyond market expectations. As interest rates swung, so did the demand for different types of money balances, with the result being unpredictable changes in liquidity preferences on the part of holders of money. Financial innovation has further blurred the distinction between the monetary aggregates, while the frequent and growing forays into the markets by Washington to satisfy its financing requirements undoubtedly had contributed to monetary instability as well. For this has added yet another unpredictable element to the demand for money, thus creating greater difficulty in forecasting when a given level of reserves in the banking system will be translated into money. By the way, if you think that money and interest rates are volatile now, wait until the banking system switches to contemporaneous reserve accounting. Under CRA, both the banks and the Fed will have even less time to adjust to changes in the banking system's needs for reserves than they do now. (For a fuller explanation of this, see the February, 1982 Economic Report.)

What will it take to get real interest rates to decline to more normal levels?

Since the rent component of money costs is unlikely to change any time soon, there must be sizable reductions made in the fear and volatility components. This means that Washington has to produce signs of progress in reducing the budget deficit. In addition, the Federal Reserve has to adopt a monetary policy that reduces the volatility in both interest rates and the money supply—something it may have already moved toward.

Why did our trading partners complain that high U.S. interest rates caused the dollar to become overvalued—yet when our interest rates fell they cut their interest rates thus maintaining the unusual spread between our money costs and theirs which contributed to the dollar's rise in the first place?

In 1981 and early 1982 inflation was still a front-burner issue for many of our trading partners. As their currencies sank relative to the dollar, their domestic inflation rates were boosted because of the higher prices that they had to pay for imported merchandise—much of which is denominated in dollars. By summer 1982, the pervasiveness of recession overtook inflation pressures, causing inflation to slow and many commodities' prices to actually decline—not the least of which was oil. An undervalued currency helps cushion the impact of recession by keeping exports strong and imports weak, yet does not do much damage to domestic prices in a period of reduced inflation. Thus when our interest rates fell, other countries quickly lowered theirs in order to help revive their domestic economies.

Why don't the rules of economics work the way they used to?

They work—we just don't follow them. For example, Keynesian economics suggests that Washington run budget deficits only in bad times and run surpluses in good times. That this rule has been violated can been seen in the historical record, whereby we have run only two annual budget surpluses in the past 25 years! Another rule is that big budget deficits and tight money do not mix. Yet, this has been the hallmark of this Administration's economic policy from the day it took office—not to mention during the 1980 Presidential campaign. As for monetarism, it has proven to be an effective medicine for bringing down inflation but does not have by itself the capacity to revive economic growth. And "supply side" economics, as the term is used today, will stimulate business investment only after two other criteria are met: Capacity utilization must be higher and real interest rates must be lower. In the absence of these two key criteria, the kind of incentives embodied in today's version of supply side economics will not be sufficient to prod businessmen into investing in new machinery and equipment so badly needed to boost productivity and to improve their competitiveness with companies based abroad.

As you can see, even the stickiest of questions can be answered. But whether these lessons will be learned by economic policymakers remains to be seen. If they don't, they will have an opportunity to learn them again, for as the philosopher George Santayana once said, "those who cannot remember the past are condemned to repeat it." M

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The Truth About Country Debt

"Neither a borrower nor a lender be."
—Polonius in Shakespeare's *Hamlet*

In the past few months a lot of paper, ink, and air time has been devoted to the subject of country debt. Authors, not all of whom are expert at all in international finance, are telling us that "hundreds of billions of dollars in outstanding loans to developing countries are at risk today," and that this "crushing debt burden threatens the international banking system with collapse." Many publications take every opportunity to assert that bankers have been "imprudent, reckless, or worse" in making these "illiquid" loans, and that they should be written off in whole or part in order that the banks "cleanse" themselves—in the process slashing their earnings, dividends, and most likely payrolls as well. One business journal claims that in international lending the banks have pursued a "greater fool theory" where there would always be someone to "bail them out" in the event of trouble.

Debt Needed For Growth

As a prominent politician of many decades ago was fond of saying: "Let's look at the record." I don't think anyone would question the notion that debt is an important means of generating growth and improved living standards. On an individual basis, without credit it would be impossible for most people to buy all but the barest of necessities. A car and a house would be out of question—not to mention things like a college education for the youngsters. At the corporate level, credit is used to pay for the cost of starting up a business, producing the goods and services, and distributing them—all of which must be paid for in advance before sales revenues come in. The need for expansion and modernization requires debt as well.

At the country level, credit is necessary for trade financing, the development of industry and infrastructure, and so on. And I would remind you that the extent to which countries have been able to purchase goods has helped expand world trade and conferred significant benefits on other countries—not the least of which is the United States, where exports of goods now account for nearly 13 per cent of the gross national product, more than double what it was 20 years ago.

TABLE I

SIZE AND MATURITY STRUCTURE OF DEVELOPING COUNTRY EXTERNAL BANK DEBT

(includes OPEC)

Year (as of June)	Total $ bil.	Due Within One Year $ bil.	Due Within One Year As % of Total External Bank Debt %	U.S. Nonfinancial Corporations: Short-Term Liabilities as % of Total %
1978	155.3	71.9	46.3	42.8
1979	203.1	91.9	45.2	45.3
1980	247.1	114.2	46.2	46.1
1981	289.0	142.5	49.3	46.9
1982	343.5	171.8	50.0	49.3

Source: Bank for International Settlements; Federal Reserve

It may be true that an increased amount of borrowing at the country level is being used to service previously incurred debt and/or pay for imports for consumption, instead of being used to develop an infrastructure to generate an income stream. However, recent developments suggest that this deterioration has not been confined to countries alone, but rather, is symptomatic of the times we live in. In other words—rather than being the result of financial mismanagement either on the part of the lender or borrower, after four years of recession, high interest rates and declining commodity prices, it would be surprising if there *weren't* problems with country debt. Indeed, if the opposite were true, one could conclude that bankers had not been doing their jobs. There would be less in the way of sunrise industries and the OPEC surplus would not have been recycled so efficiently. At any rate, I would like to show the environment in which the debt situation made the

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headlines, and demonstrate that the worst appears to be over when it comes to these debt burdens.

Politics And Economics

First of all, the country debt situation should be divided into two major geographical areas: The Eastern Bloc and Latin America. After many years with no unusual developments, several Eastern Bloc countries were suddenly unable to service their debt, not only because of recessions in their major hard-currency export markets, but because of a change in political relations between the United States and Russia. As was observed in the September 1982 Economic Report, "some of the so-called problem loans confronting major banks today are the result of initiatives taken in Washington and elsewhere that in effect have made private banks and international markets the cutting edge of foreign policy." The Eastern Bloc encountered difficulties in part because of the different political climate imposed by the United States.

Nevertheless, the debt situation leaped to the front pages, for it had been unheard of for a country to declare that it simply did not have the money due its creditors. Not surprisingly, concern was heightened when several major Latin American countries made similar announcements—each for different reasons. In all of these cases, outstanding debt was rescheduled and new credit provided by a consortium of international banks and international lending agencies such as the International Monetary Fund. The September Economic Report discussed how the debt problem developed, beginning with quantum leap upward in oil prices late in 1973. What I would like to devote the balance of this Report to is a discussion of how this debt situation is improving.

All Maturities Have Shortened ...

One of the reasons why some countries find debt difficult to service is that it has increasingly become short term in nature. Table I shows that bank debt due within one year has risen as a per cent of total bank debt incurred by developing countries from 46 per cent at midyear 1978 to 50 per cent by midyear 1982. But this did not occur in a vacuum, as you can see from the trend of short-term debt for U.S. nonfinancial corporations during this time; it rose almost twice as fast! And as the U.S. government's debt managers will attest, increasing reliance on short-term debt leads to an increasing need to roll it over. In the case of country debt, this has turned manageable liquidity problems into a global financial challenge.

Plainly, if governments could transform their short-term debt into medium- and long-term obligations, their present difficulties would substantially ease. It would also make them less subject to the uncertainties of

TABLE II

NON-OPEC DEVELOPING COUNTRIES' DEBT BURDEN

Year	Medium- & Long-Term External Debt As % GDP	Medium- & Long-Term External Debt As % Goods & Services Exports	Principal & Interest Payments As % Goods & Services Exports	U.S. Nonfinancial Corporations: Interest Payments As % Cash Flow
1973	16.6	88.7	14.0	28.1
1974	16.3	80.6	11.5	36.8
1975	18.3	97.7	14.0	25.2
1976	20.5	102.6	13.9	21.0
1977	22.1	104.9	14.0	19.7
1978	23.7	111.2	17.3	20.7
1979	22.7	101.9	18.1	23.5
1980	21.8	92.9	16.3	25.9
1981	24.3	103.2	21.0	26.2
1982(e)	25.2	109.1	22.3	30.3

Source: International Bank for Reconstruction and Development; Commerce Dept.; MHT estimates

interest rates; the combination of shorter and shorter debt maturities with ever-rising interest rates was largely responsible for today's debt concerns. As you can see from Table II, while medium- and long-term external debt of the non-OPEC developing countries has held fairly steady relative to the size their economies and to their exports over the past few years, their interest and principal repayments as a per cent of exports have increased markedly. However, so did interest payments as a per cent of cash flow of U.S. nonfinancial corporations.

... But Debt Burdens Are Diminishing ...

Nevertheless, the ability to handle this debt seems to be improving. For one thing, interest rates have come down dramatically in the past few months. Each percentage point decline in the London Interbank Offered Rate (LIBOR) reduces the annual interest payments of Brazil and Mexico together by at least $1 billion. Consequently, the seven percentage point drop in LIBOR since mid-1982 has already shaved interest payments of these two countries alone by $7 billion annually—equivalent to over ten per cent of all LDC interest payments in 1982 (estimated at $65 billion). Aside from this, it would appear that the non-OPEC developing countries' current account balance has begun to improve as a result of continued growth in merchandise exports and a curtailment of imports.

As Table III indicates, in 1982 there was a reduction in these countries' aggregate deficit to below 1980 levels. And with merchandise exports estimated to have grown

some 7½ per cent during this time, the ratio of the current account deficit to merchandise exports has dropped from a recent high of 27 per cent to 21 per cent. This is the lowest since 1979 and is far below the peaks reached in 1974 and 1975. External debt outstanding of the non-OPEC developing countries was not much higher in 1982 than in 1978 when compared with exports. And, as you can see, interest payments as a per cent of exports and reserves has begun to fall as well.

... With Further Progress Likely

Besides these improvements already underway, there are other developments pending which will further alleviate this debt situation. For one thing a resumption of growth in the United States as well as in the countries of the industrialized West will go a long way toward helping the less developed countries manage their debt. If LDC exports grow no more this year than they have on average during the first year of recovery from the three previous cycles then the dollar value of their exports will rise by over $30 billion—equivalent to nearly half of their total interest payments in 1982!

Increased demand for exports will undoubtedly firm up commodities prices. Prices of the goods that developing countries export must return to their proper position relative to other prices especially oil, if these countries are ever to reduce their debts to more manageable proportions. For the international payments system never had a situation where the same countries would run consistent and growing payments deficits year after year as it has since OPEC first boosted oil prices in 1973.

TABLE III

EXTERNAL POSITION OF THE NON-OPEC DEVELOPING COUNTRIES

Year	Non-OPEC Developing Countries Current Account Balance	Non-OPEC Developing Countries Merchandise Exports	Current Account Balance As % Merchandise Exports	Interest Payments As % of Exports Plus Reserves
	$ bil.	$ bil.	%	%
1973	-12	86.4	13.9	5.7
1974	-37	123.0	30.1	5.5
1975	-47	120.7	38.9	7.4
1976	-33	140.3	23.5	6.8
1977	-29	164.8	17.6	7.0
1978	-31	188.3	16.5	8.2
1979	-48	244.6	19.6	9.5
1980	-75	311.9	24.0	10.9
1981	-86	324.2	26.5	15.6
1982(e)	-70	335.0	20.9	15.4

Source: International Monetary Fund; International Bank for Reconstruction and Development; MHT estimates

Having said this, it must be recognized that there remains an enormous overhang of debt, particularly short-term bank debt, which could affect the non-OPEC developing countries for many years, even in a period of economic growth. Thus, one must come to the conclusion that countries, like corporations, need a mechanism to reduce their dependence on fluctuations in the cost and availability of short-term credit. Right now, many companies in the private sector have begun funding a sizable portion of their short-term debt in the bond markets thereby improving their balance sheets. Some developing countries, however, have no such option other than to reschedule. If only modest amounts of short-term debt could be transformed into medium- and longer-term obligations, the present difficulties of several developing countries would be significantly alleviated, diminishing the constant rollover problem and improving key liquidity ratios back to more manageable levels, such as those of the mid-1970s.

Although no such mechanism now exists, this is an area in which official institutions should assume an active role. Indeed, they should consider providing not only long-term debt, but equity capital as well. This would help to reduce strains in the debt markets while at the same time gearing the return on this equity investment to the ability of the borrowing countries to pay—especially if dividends were to be tied to the price of these countries' export commodities.

Conclusions

Let me sum it up. First of all, debt is an integral and a necessary part of economic growth and improved living standards. Second, it is the function of banks and other financial intermediaries to get savers and borrowers together in order to meet their respective needs. Admittedly, the debt situation for some countries had become burdensome. However, this was exacerbated by the withdrawal of liquidity by some marginal lenders, and not because of a worsened internal economic climate. Indeed, such recent developments as a reduction in imports and consequent improvement in trade accounts, along with lower interest rates and a revival of economic growth are signs that many countries have turned the economic corner. This process will reduce debt burdens, but it would be enhanced if a facility were made available to governments that would permit them to exchange short-term debt for long-term debt (or equity) as private sector companies do.

As necessity has many times tended to be the mother of invention, I am hopeful, if not confident, that such a facility will soon develop. Until then, just think about what kind of world this would be if everybody listened to Polonius.

—Research Associate
Marc M. Goloven, V.P.

The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

FEBRUARY 1983

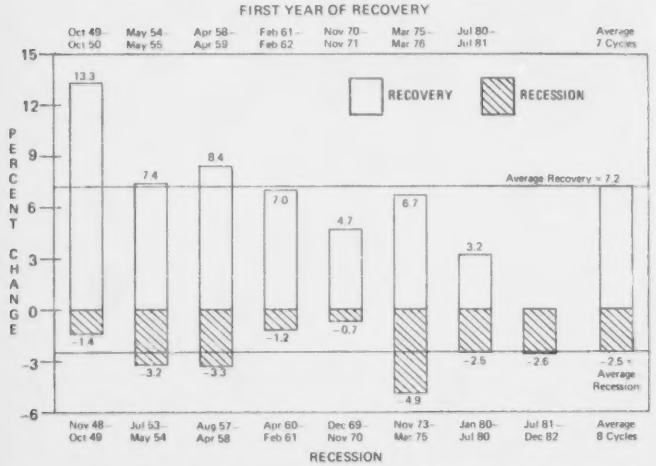
Business Conditions Update

The up-and-down U.S. economy appears to be expanding once again following the fourth quarter's decline. Unlike previous rises in economic activity, however, this one has the potential for lasting at least through 1983 (see table inside). If it does, it would mark the first instance of four consecutive quarterly increases in the real GNP since 1978. That would probably enable the National Bureau of Economic Research, the umpire of the business cycle, to declare that the recession which began in July 1981, has ended, and that a new expansion is underway.

Lower Interest Rates . . .

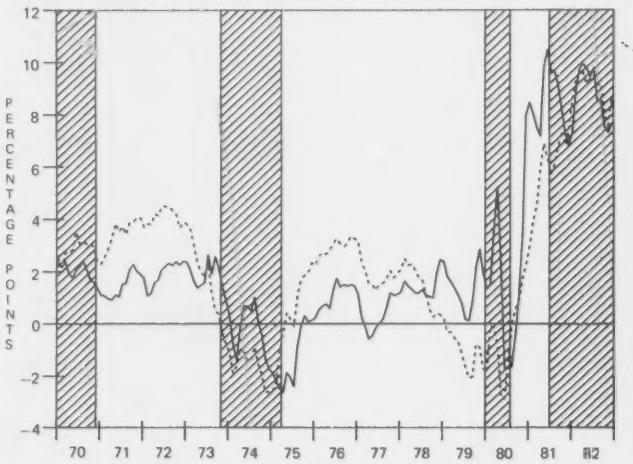
This assessment of the state of business is based largely on developments that have *already* occurred, rather than a forecast of what *might* happen. First of all, interest rates have fallen significantly. The banks' prime lending rate has dropped from 16½ percent to 11 percent, while rates on six-month commercial paper are down from about 14 percent to eight percent. In the longer-term area, interest rates on high-quality corporate bonds have fallen approximately three percentage points, while rates on home mortgages are down nearly four percentage points.

CHART I
CHANGES IN REAL GNP IN CYCLICAL PERSPECTIVE



These lower interest rates have revived two of our key industries. After touching a 20-year low selling rate of four million units during the month of June, new domestic cars today are selling at rates above six million—a 50 percent improvement in eight months' time. New home construction has perked up as well; the annual rate of new private housing starts is nearly double yearend 1981's level. Although homebuilding and automobiles do not bulk as large in the U.S. economy today as they did in the past, they are still important enough to have caused a ripple effect throughout the economy.

CHART II
REAL PRIME RATE (LINE)
VS. REAL AA UTILITY RATE (DOT)



You can see this improvement in the nation's basic industries. Output of lumber, paperboard, and steel has been rising for some time, now. Lumber is up 16 percent, paperboard 11 percent and steel 45 percent from their respective lows plumbed in 1982. Reflecting an improved balance between supplies and demand, most basic commodities' prices started to climb several months ago and, as a group, are back to their levels of last fall. Recently, construction contract awards hit a three-year high, while new orders for durable goods have climbed, too. January's drop in unemployment and rise in payroll employment may be a sign that the labor markets have begun to feel the effects of this turnaround as well.

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This pickup in activity, coming on the heels of earlier cuts in production, led to a massive inventory correction in 1982's fourth quarter. While real final sales were rising at a healthy 3.1 percent annual rate, the highest rate of growth since first-quarter 1981, inventories were being liquidated at the fastest pace in history. During the fourth quarter real inventories fell by $17.7 billion, pulling down the overall gross national product by an annual rate of 2.5 percent.

Because of this massive liquidation, shortages began to appear in many lines—not the least of which were automobiles, where supplies sank to a 12-year low in December. As a result, production of cars and many other items increased in January, and are scheduled to rise further in February. This leads me to suspect that this most recent phase of inventory liquidation is just about over. Such a development alone will give a lift to the economy during the first quarter of 1983. If final sales do no more than hold at their fourth quarter level, an end to inventory liquidation would lift the real GNP in the current quarter by about five percent at annual rates.

Some analysts, viewing such numbers, might be tempted to mark up their forecasts for the balance of the year. Even now, many suspect that, in forecasting a weak recovery, they may be underestimating the latent strength in the economy. To be sure, there is every reason for optimism. January's gain in industrial production was the second largest monthly rise in over two years. Further gains seem likely. The protracted slump has undoubtedly produced a great deal of pent-up demands for such key items as cars, houses, and goods for business use. The consumer could surprise us by lifting his spending rates faster than many now anticipate. This would frustrate producers' efforts to rebuild inventories, and cause an even steeper upturn in production in the months ahead. Other positive developments which could produce a better-than-expected recovery include the continued efforts by the Federal Reserve to depress interest rates and ensure an adequate supply of liquidity for the economy, as well as the recent softening in oil prices.

. . . Plus Lower Oil Prices . . .

A lot has been written lately about the impact of falling oil prices—most of it incorrect. While there are no doubt some losers, there are far and away more winners as the price of oil heads down. At the country level, you should remember that there are many more who import oil than export it. A large number of these oil importers are developing countries, whose own export prices have declined significantly as oil shot up. As the January, 1983 Economic Report observed: "Prices of the goods that developing countries export must return to their proper position relative to other prices *especially oil*, if these countries are ever to reduce their debts to more manageable proportions." Lower oil prices represent the first (non-inflationary) step in this direction.

In the U.S., lower oil prices will lead to faster economic growth. We calculate that each dollar per barrel decline in oil prices could, in time, lead to 0.2 percent more growth in the real GNP. As people find that their energy budgets go further, they will have more to spend on other goods and services. This, in turn, will expand production, leading to increased needs for workers, materials and machinery, etc. Eventually our appetite for imports would increase, thus benefiting our trading partners.

Lower oil prices will cut inflation, too. As you saw from January's producer price index, which fell by the most for any month in the postwar era, a drop in energy prices has a powerful effect on the overall price level. At the consumer level, we would expect each dollar per barrel drop in the price of oil to slow inflation by 0.2 percent. Interest rates will be lower, too; long-term rates could fall by over ten basis points per dollar decline in oil. Unemployment will be lower, while incomes, business earnings—and Federal tax revenues—will be greater.

On the other hand, some of the reasons offered for optimism don't seem to make much sense. For one thing, the notion that a severe recession tends to be followed by a vigorous recovery just does not hold up, when examined statistically. As you can see from Chart I, there have only been four cycles out of the past seven in which there was a relationship between severity of recession and strength of recovery. That is to say—a worse-than-average recession would lead to a better-than-average rebound and vice-versa. Then there are those who believe that there is a systematic relationship between the rate of growth in the money supply and the subsequent behavior of the economy. Since the money supply in the last half of 1982 expanded at annual rate of nearly 15 percent, those who follow this credo also look for strong growth in 1983. However, these are the same folks who, after watching the money supply jump by an annual rate of eight percent between December 1981 and June 1982, thought the economy would rise sharply in second-half 1982!

At the other end of the spectrum are those who feel that the upswing is so fragile that it is bound to be snuffed out in short order. They point to such factors as real interest rates, which, although down from their half-century peaks, are still high when compared with historical experience (Chart II). This makes it very costly for business to borrow, thus step up spending enough on plants and equipment to perpetuate the upswing much beyond the initial kick it will get from the end of inventory liquidation.

The pessimists assert that real interest rates are unlikely to come down appreciably for several reasons. For one thing, the Federal Reserve may soon run out of elbow room to push down nominal rates, since the recent uptick in long-term interest rates suggests that some financial market participants are becoming concerned over the prospects for renewed inflation. Short-term rates may remain high because the demand for money by the private sector will increase as a byproduct of the faster pace of economic activity, while the government's need for funds to finance its enormous budget deficits increases, too. Some think that the continued high rate of unemployment will drain consumer confidence, while others suggest that the marked slowing of inflation may induce people to hold off buying postponable goods, waiting for lower prices. Internationally, there is no shortage of problems, ranging from concern over debt burdens of various countries, to the growth of protectionism and the effects of the overvalued dollar on the ability of U.S. businessmen to market their goods abroad.

. . . Equals Economic Recovery

As you probably have determined by now, I think the most likely course of activity in 1983 will be midway between the path projected by optimists and that expected by the pessimists. The important point to remember, however, is that virtually every economist both in and out of government expects that 1983 will be a much better year than 1982. Indeed, most think it will be the best year for the economy in four years with nearly every region and sector posting at least some increase by yearend.

Of course, the stronger the rebound the more momentum it will have to carry it into 1984. And by producing more tax revenues for Washington, a stronger recovery would lessen the chances that Washington's huge deficits will cause renewed problems down the road for the U.S. economy, either in the form of higher inflation, another recession, or both. But it wouldn't eliminate these threats: The more the Federal budget deficit is trimmed this year, the better I will feel about next year and the years to come. M

February, 1983
MHT FORECAST OF GROSS NATIONAL PRODUCT
(Seasonally Adjusted Annual Rates)
In $ Billions

	< Actual						Projected >					
	1982				YEAR 1982		1983				YEAR 1983	
	I	II	III	IV	LEVEL	% CH	I	II	III	IV	LEVEL	% CH
Gross National Product	2995.5	3045.2	3088.2	3101.3	**3057.5**	**4.1**	3168.1	3204.1	3273.9	3346.2	**3248.1**	**6.2**
GNP: $72	1470.7	1478.4	1481.1	1471.7	**1475.5**	**−1.8**	1490.6	1498.4	1515.3	1533.2	**1509.4**	**2.3**
% Change, Annual Rates	−5.1	2.1	0.7	−2.5	**−1.8**		5.2	2.1	4.6	4.8	**2.3**	
Consumption	1919.4	1947.8	1986.3	2034.6	**1972.0**	**7.0**	2060.5	2087.5	2130.3	2170.3	**2112.2**	**7.1**
Durables	237.9	240.7	240.3	251.7	**242.7**	**3.5**	251.2	257.8	266.6	272.8	**262.1**	**8.0**
Non-Durables	749.1	755.0	768.4	778.3	**762.7**	**3.8**	782.9	786.9	795.1	803.6	**792.1**	**3.9**
Services	932.4	952.1	977.6	1004.5	**966.6**	**10.6**	1026.5	1042.9	1068.5	1093.9	**1058.0**	**9.4**
Investment	414.8	431.5	443.3	397.9	**421.9**	**−10.5**	435.6	443.4	466.0	481.0	**456.5**	**8.2**
Non-Residential	357.0	352.2	344.2	336.6	**347.5**	**0.4**	322.9	319.1	324.6	331.0	**324.4**	**−6.6**
Producers Durable Equipment	215.6	208.6	203.0	196.2	**205.8**	**−4.9**	192.0	193.0	198.8	205.2	**197.2**	**−4.2**
Structures	141.4	143.6	141.3	140.4	**141.7**	**9.2**	130.9	126.1	125.8	125.8	**127.1**	**−10.3**
Residential	93.4	95.5	94.3	99.8	**95.8**	**−8.8**	112.0	119.3	127.7	133.9	**123.2**	**28.7**
Inventory Changes	−35.6	−16.2	4.7	−38.5	**−21.4**		0.7	5.0	13.7	16.1	**8.9**	
Net Exports	31.3	34.9	6.9	−6.9	**16.6**		−10.7	−14.2	−18.9	−19.1	**−15.7**	
Government Purchases	630.1	630.9	651.7	675.7	**647.1**	**8.4**	682.7	687.4	696.5	713.9	**695.1**	**7.4**
Federal Defense	166.2	176.2	182.7	188.9	**178.5**	**16.1**	192.5	196.6	202.8	210.8	**200.7**	**12.4**
Federal Civilian	83.5	68.2	76.3	87.2	**78.8**	**4.8**	87.1	84.2	83.1	87.6	**85.5**	**8.5**
State & Local	380.4	386.6	392.7	399.6	**389.8**	**5.9**	403.1	406.5	410.7	415.6	**409.0**	**4.9**
Final Sales: $72	1486.1	1482.7	1477.8	1489.3	**1484.0**	**−0.6**	1490.6	1496.4	1509.7	1526.8	**1505.9**	**1.5**
% Change, Annual Rates	0.2	−0.9	−1.3	3.1	**−0.6**		0.3	1.6	3.6	4.6	**1.5**	
GNP Price Index (1972 = 100)	203.7	206.0	208.5	210.7	**207.2**	**6.0**	212.5	213.8	216.1	218.2	**215.2**	**3.8**
% Change, Annual Rates	4.3	4.6	5.0	4.3	**6.0**		3.5	2.5	4.2	4.1	**3.8**	
PCE Deflator (1972 = 100)	202.2	204.0	207.7	210.2	**206.0**	**5.9**	211.9	213.5	215.9	217.9	**214.8**	**4.3**
% Change, Annual Rates	4.9	3.6	7.5	4.9	**5.9**		3.2	3.1	4.6	3.9	**4.3**	
Consumer Price Index (1967 = 100)	283.6	286.8	292.1	294.0	**289.1**	**6.1**	296.5	298.9	301.9	304.8	**300.5**	**3.9**
% Change, Annual Rates	3.2	4.6	7.6	2.6	**6.1**		3.5	3.3	4.0	4.0	**3.9**	
Total Personal Income	2510.4	2552.5	2592.4	2623.0	**2569.6**	**6.4**	2656.3	2678.3	2743.9	2801.9	**2720.1**	**5.9**
Disposable Personal Income	2117.1	2151.5	2198.1	2223.5	**2172.6**	**7.1**	2249.0	2270.1	2341.5	2390.8	**2312.8**	**6.5**
Savings Rate	6.6	6.7	6.9	5.8	**6.5**		5.7	5.3	6.3	6.5	**5.9**	
Employment Rate	56.6	56.4	56.2	55.8	**56.2**		55.6	55.8	56.0	56.3	**55.9**	
Unemployment Rate	8.8	9.4	10.0	10.7	**9.7**		10.5	10.3	10.0	9.8	**10.2**	
Indus. Production (1967 = 100)	141.8	139.4	138.2	135.1	**138.6**	**−8.1**	137.3	139.6	142.5	145.9	**141.3**	**2.0**
Housing Starts (000)	920.3	952.0	1118.3	1250.7	**1060.3**	**−3.6**	1358.0	1460.5	1524.9	1544.8	**1472.0**	**38.8**
Domestic Auto Sales (000)	5733.3	5466.7	5504.3	6133.3	**5709.4**	**−8.2**	6166.5	6402.3	6670.5	6828.0	**6516.8**	**14.1**
Corporate Pre-Tax Profits	171.6	171.7	180.3	180.6	**176.1**	**−24.1**	193.5	194.5	194.9	204.9	**197.0**	**11.9**
− Taxes	56.7	55.3	60.9	60.2	**58.3**	**−28.2**	65.9	66.3	65.9	69.7	**67.0**	**14.9**
Net Profits	115.0	116.3	119.4	120.4	**117.8**	**−21.9**	127.6	128.2	129.0	135.3	**130.0**	**10.4**
− Dividend Payments	68.8	69.3	70.5	72.4	**70.3**	**7.9**	73.7	75.0	76.3	77.7	**75.7**	**7.7**
Undistributed Profits	46.1	47.0	48.8	48.0	**47.5**	**−44.7**	53.9	53.2	52.7	57.6	**54.3**	**14.5**
+ Depreciation	208.8	216.5	223.7	231.9	**220.2**	**16.3**	240.5	247.6	254.7	261.3	**251.0**	**14.0**
− Inventory Profits	4.4	9.4	10.3	13.4	**9.4**	**−61.9**	8.9	7.1	9.7	10.4	**9.0**	**−3.7**
Net Cash Flow	250.5	254.1	262.2	266.5	**258.3**	**3.1**	285.4	293.8	297.7	308.5	**296.3**	**14.7**

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

MARCH 1983

Why Interest Rates Are High

Bankers must be very responsible people. For whenever anything goes wrong in the economy—we seem to be responsible. Don't take my word for it, ask Treasury Secretary Donald T. Regan. He said last month that the banks were responsible for high interest rates: "I think that banks, faced with a lot of problem loans, both domestic and international, are doing their utmost to keep their earnings up by keeping their interest rates up." This was followed by several articles in the financial press which added credence to the Secretary's remarks by comparing the rates that banks charge to prime business customers with a money market rate in percentage point terms alone, without regard to other factors.

I have discussed the subject of interest rates many times before, so some of what follows will not seem new to regular readers of the Economic Report. However, I feel constrained to respond to these allegations, for they are misleading, to say the least. Let me tell you why I think interest rates are high, and whose responsibility it is to bring them down.

Bank Lending Spreads ...

Superficially, it does appear that the spread between the rates banks charge on money they lend and pay for money they attract has widened dramatically in recent years. In 1977, for example, little more than one percentage point separated key money market rates from the banks' lending charges on prime business loans. Today that spread is as high as three percentage points. However, because of the rising interest rate environment we have had in recent years, it is inaccurate to look at spreads in percentage point terms alone. This is because banks, like any other business, set their prices in relative terms compared with their costs, not absolute terms. Between 1977 and 1982 short-term interest rates about doubled. Obviously, charging the same absolute spread in 1982 as in 1977 would have resulted in a percentage markup only half as great. In relative terms, then, the spread between the prime rate and the banks' cost of funds did not increase as much as it seems.

But this is not all. For while the posted prime is an important benchmark rate, it does not accurately represent the interest rates that banks charge on many short-term loans. According to the Federal Reserve Board, the weighted-average interest rate on short-term commercial and industrial loans today is as much as one percentage point lower than the posted prime. This reflects the growing tendency of large, top-rated corporations to be able to negotiate rates below the posted prime because of their ability to access the domestic and international money markets, where rates are lower. Looking at banks' lending charges this way discloses that the average rate on short-term loans was not unusually high in 1982, when compared with money-market rates in either absolute or relative terms.

As for the banks' cost of funds, I would like to point out another misconception. This is that the latest interest rate on Federal funds, commercial paper, or certificates of deposit represents the average cost of funds to banks at a given moment in time. It does not, since banks obtain money from a variety of sources with maturities ranging from overnight to several years in duration. One must combine these sources into a blend, or weighted average cost of funds to get the true picture of a bank's money costs. If one does, one will find that these costs are even closer to the average rate charged on short-term business loans—both in absolute as well as in relative terms.

... Are Less Than They Seem

Even this does not tell the entire story. For a bank's interest cost structure reflects more than simply a spread between the average rate earned on earning assets (loans) and the average rate paid for interest-bearing funds. You see, spread is not the same as yield, which takes into account not only interest-bearing funds but interest-free sources as well, such as demand deposits. And in recent years, as a result of both deregulation and a change in corporate deposit habits, banks have seen a dramatic decline in the amount of interest-free funds available to them.

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At Manufacturers Hanover, the percentage of funds coming to us interest-free that we use to finance our assets has been cut in two since 1976, from nearly 20 percent then to only about 10 percent today. Add to this the deregulation of consumer deposits, which replaced interest-free checking accounts and low-interest savings accounts with NOW accounts, money market accounts and Super NOWs and you can see the addition of another sizable cost to the interest cost structure of the banking system. And the banks are not only relying more on interest bearing deposits, they have to make sure they are paying competitive rates, since these interest bearing deposits are becoming increasingly market-rate sensitive.

NET YIELD ON EARNING ASSETS AT 20 MONEY CENTER BANKS

Year	Earning Asset Yield	Interest Bearing Liabilities Cost	Interest Rate Spread	Cost of All Funds	Net Yield on Earning Assets
	(1)	(2)	1–2=(3)	(4)	1–4=(5)
1975	8.91%	6.76%	2.15%	5.43%	3.48%
1976	8.16	5.91	2.25	4.72	3.43
1977	8.13	5.87	2.26	4.75	3.38
1978	9.50	7.26	2.24	5.96	3.54
1979	11.81	9.82	1.99	8.26	3.55
1980	13.60	11.97	1.63	10.14	3.46
1981	16.11	14.67	1.44	12.72	3.39
1982*	14.82	12.93	1.89	11.20	3.63

*Average of first three quarters
Source: Robinson Humphrey/American Express Inc; MHT.

The bottom line is quite different from the top line. As you can see from the table, while there was a 45 basis point improvement last year in the interest rate spread at 20 money center banks, the figure that affects profits, net yield on earning assets, showed an improvement of only 24 basis points. And these are in absolute terms; in relative terms, on both the interest rate spread and net yield basis, the difference between what we charge and what we pay was lower in 1982 than seven years earlier!

Critics of bank lending charges might have more of a leg to stand on when they look at consumer lending rates. For unlike the prime rate and other lending rates to business, which have come down considerably from their recent peaks, consumer lending rates have hardly budged at all—and in some cases are higher today than one and two years ago.

Here, too, there is an explanation. For one thing, consumer loans tend to be smaller than business loans, thus involve more paperwork (loan applications, credit checks and so forth) per million dollars, for example, than a business loan. Obviously this is a cost which has to be factored into the price of the loan. And, unlike business loans, loans to consumers tend to be at fixed rates of interest for several years at a time. This means that a loan which is profitable when it is initially approved, may eventually become unprofitable if money costs rise above the return on the loan—as has been the case so many times in the past. There are greater risks involved in loans to consumers than to businesses so this must be factored into the cost of the loan. Until recently, most consumer lending operations were not profitable because of interest rate ceilings. These have been lifted in most states, suggesting that the high rates on some types of consumer loans may be just an immediate after-effect as these departments seek to make up for lost profitablity.

One thing must be remembered in discussing the banks' pricing policies. This is the fact that the banks are not the only source of funds for both individuals and business. What is more, the commercial banks may be losing ground to other companies in the financial services industry which suggests that bank loan pricing cannot get too far out of line with these other sources.

Interest Rates Are High ...

Let me turn from bank lending rates to interest rates in general. For in the final analysis, the banks can only squeeze their interest rate spreads so far in bringing down the cost of borrowing to business and consumers. If the cost of money, itself—in other words, the general level of interest rates in the money markets—is high, then there's no way that bank lending charges can get down low enough to satisfy the Administration, or anyone else, for that matter.

Therefore, it is necessary to consider why market rates of interest are still high—not only in nominal or quoted terms, but in real terms, when measured against the current rate of inflation. For it has been the high real rates of interest that have been largely responsible for slowing the economy. Indeed, when real interest rates hit 50-year highs between mid-1981 and mid-1982, they were subsequently followed by a rise in business failures to half-century highs which produced the worst recession since the 1930s.

Of course, real interest rates have come down somewhat from these half-century records. However, they are still well beyond the boundaries that both business and consumers have grown accustomed to over the last several decades. The December Economic Report offered the following explanation: "The greater volatility of both interest rates and the money supply following

the Federal Reserve's shift to monetarism three years ago seems to have added a 'volatility premium' to the level of interest rates besides the inflation and rent premiums, both of which had been embodied in interest rates for many years. In the summer of 1981, another premium might have been added, one that, for lack of a better term, could be called a 'fear' premium.

"The markets got scared beginning in the summer of 1981 when Washington revealed that the government's budget deficits were not going to get smaller and eventually disappear by mid-decade, but rather, were going to get bigger and expand into the 12-digit territory. The fear was that either these deficits and their associated borrowing requirements would overwhelm the money and credit markets, driving up interest rates in the process—or that they would not; that the Federal Reserve would monetize these deficits, but in the process, set the stage for a new round of inflation."

... Because Budget Deficits ...

I would say that these fears are very much in evidence today. The volatility premium no doubt has shrunk because the Federal Reserve since July 1982 appears to be focusing more on managing interest rates and less on managing the quantity of money. Indeed, short-term interest rates have become extremely stable day-to-day —notwithstanding their precipitous decline last summer. But the fear premium is still very much in evidence. In the money markets, there is a fear of a renewed credit squeeze if the Federal Reserve once again becomes concerned over money supply growth and seeks to slow it down. And the bond markets are concerned about the higher rate of inflation that seems likely to arise sometime down the road if the Fed does *not* concern itself with money supply growth, and allows recent hefty rates of increase to continue.

Before you conclude that there is a Catch-22 here suggesting that interest rates are bound to rise one way or another, let me point out that they need not. However, this would require action by the Administration and the Congress. The key to lower interest rates deals with current and prospective borrowing by the Treasury to meet its huge, unprecedented budget deficits. No matter how you look at it, the deficit is far too large, given the state of our economy, the financial markets, and the availability of savings to finance them. Whether you compare the deficit with the gross national product, or total Federal borrowings with the supply of savings, you must conclude that we are in uncharted territory.

To make matters worse, the underlying imbalance between our spending programs and the revenue-generating capacity of the tax system at reasonable levels of employment (the structural deficit) promises to increase as fast as the cyclical portion of the deficit declines. This means that we cannot count very much on economic recovery to reduce the deficit and get the Federal government out of the way of the private sector in the competition for funds in the financial market place. The implication is that a new clash between government financial needs and the needs of business, homebuyers, farmers and consumers is on the horizon. Since the government is an insensitive borrower (it borrows what it needs, when it wants to, regardless of the cost), the financial markets, in anticipation of the higher interest rates that will result from this clash, are keeping interest rates high today in order to protect themselves against tomorrow.

In criticizing the banks for keeping interest rates high, the Administration is trying to deflect public opinion from its own economic mistakes. This year's budget document contains the same amazing revelation as last year's concerning the revenue impact of the Economic Recovery Tax Act (ERTA) of 1981. The Office of Management and Budget estimates that between 1982 and 1986, ERTA alone will cost the Federal government $609 billion in tax revenues. That's 72 percent of the $850 billion cumulative deficit that the Administration believes it will run during this time! The balance, I am sure, can easily be accounted for by the impact that these deficits had on the level of interest rates and the subsequent recession that these high interest rates caused. High interest rates, of course, added to government spending and subtracted from government tax revenues, while the recession cut further into Federal tax revenues while increasing Federal expenditures on unemployment insurance, and so forth.

... Continue To Grow

The time has come for the Administration to stop blaming others for its misdeeds and start looking at its own policies. It should be clear by now that the original plan to boost government revenues by cutting taxes has not worked and will not work. It should also be obvious that using lower revenues as a club to force Congress to cut spending has only a limited effect. If you don't believe me, look at the record: With only two budget surpluses in the past quarter of a century, when did lack of revenues ever constrain the government from spending?

Bankers may indeed be very responsible people—but it is the Administration that is responsible for keeping interest rates high, not us. M

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
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APRIL 1983

The Doughnut or the Hole?

Now that inflation has cooled, national attention is focusing on unemployment. The jobless rate has been above ten percent since September, 1982—setting a postwar high in the process. It has been eight percent or higher in every month since October 1981 and April 1980 was the last time it was below seven percent. By contrast, the unemployment rate averaged less than seven percent from 1976 through 1981. It has averaged 5.4 percent over the entire postwar era—and was no higher than four percent every single month from December 1965 through January 1970.

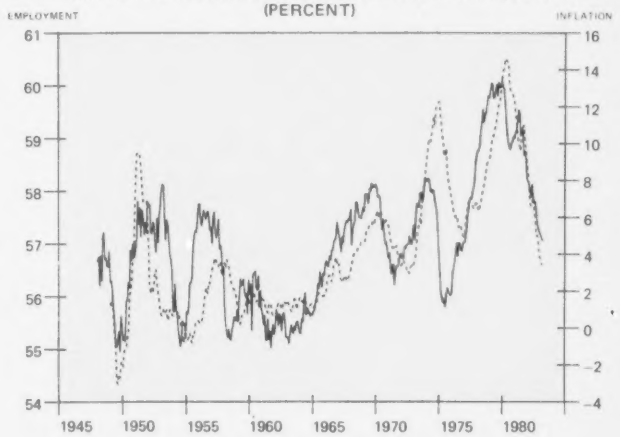
Not surprisingly, this trend has generated much concern. In Washington, a bill was recently signed into law by the President which would create nearly one million jobs at a cost of close to $5 billion. Elsewhere, there is more and more talk about the U.S. facing a period of prolonged high rates of unemployment, and more specifically, of families, cities and regions no longer expecting much improvement in their economic fortunes because of the changed nature of our economy.

Today's Employment Levels...

While these unemployment trends are most unfortunate, we should not overlook developments on the other side of the coin: Employment. For even while the jobless rate continues to run close to its postwar highs with the number of unemployed up almost 50 percent in two years, the number of people with jobs is only two percent (or 1.9 million) below its all-time high set in April, 1981. What is more, the employment rate (the number of people employed divided by the over-16 population) is about equal to its postwar average of 57 percent. This is down from the record 60 percent reached during 1979, when the unemployment rate averaged less than six percent. However, it does equal the 57 percent rate posted in January 1977—when the unemployment rate was 7.5 percent.

Without minimizing the relevance of the unemployment statistics (especially to the unemployed) I would like to make a few points about employment. First, the employment figures are extremely important to the state of the economy, perhaps even more so than the unemployment numbers. There are several reasons for this. For one thing, statistically, the employment numbers are

CHART I
EMPLOYMENT RATE (LINE) VS. INFLATION RATE (DOT)
(PERCENT)



more reliable than the unemployment numbers. Even with today's high jobless totals, the employment numbers are nearly nine times the size of the unemployment figures, suggesting more possibility for sampling error in measurements of unemployment. Even more important, there are conceptual problems regarding exactly who is unemployed. Besides those people who lose jobs, the unemployed can include those who would like to have jobs, regardless of how seriously they search for work or whether they are the primary support of their households. The employment numbers, on the other hand, constitute a more precise concept: Either you are working or you are not.

Those who are working, of course, are those who earn the bulk of the nation's personal incomes. Last year income earned by people working for themselves or for others accounted for seven out of every ten personal

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income dollars. Since consumer spending accounts for two-thirds of the GNP, you can see where the employment statistics have an important role to play: Those who don't work don't have much to spend.

TABLE I

CIVILIAN LABOR FORCE PARTICIPATION RATE

(Percent)

Year	Total	Males	Females
1947	58.3	86.4	31.8
1964	58.7	81.0	38.7
1982	64.0	76.6	52.6

Source: Department of Labor, Bureau of Labor Statistics

Right now, with the economy barely emerging from recession, more spending is clearly desirable. However, there have been times in the past when people were seeking to spend more than there were goods available for them to buy. This led to inflation. Even though it is quiescent now, a number of economists have begun to express concern that inflation is about to worsen. They base this on recent developments in money supply growth which, admittedly, has been quite rapid. However, it takes time before money growth trends surface in price trends. A more immediate explanation of inflation can be found in the employoment rate. As you can see from Chart I, it is possible to associate the percentage of the population employed with the rate of inflation—at least in a modest way. When the employment rate rises the inflation rate tends to rise, too. And as you can see from the chart, it does not take long before this happens. But as you can also see from the chart, when the employment rate falls the rate of inflation falls as well.

...Suggest Neither Imminent Inflation...

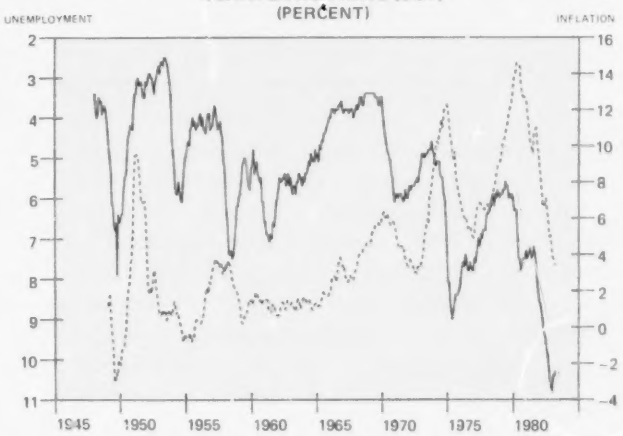
The employment rate also provides a better explanation of inflation than the unemployment rate. This is not just a recent development, either. As you can see from Chart II the unemployment rate does not bear a close relationship to the rate of inflation even though logic would suggest there might be one. Most people believe that inflation results from an overheated economy, where too much demand pushes up wages and prices. A recession is said to remove some of this pressure as idled workers and excess capacity reduce the appetite of labor for wage increases and business for price increases.

The idea that there is such a trade-off between the inflation rate and the unemployment rate goes back to work first done by A.W. Phillips of the London School of Economics. He plotted rates of unemployment and increase in wages for Britain from the 1860s to the 1950s. Wage inflation was considered to be a good stand-in for price inflation since wages generally accounted for as much as three-quarters of the final cost of goods produced. Phillips showed that periods with high unemployment had relatively low inflation rates, while years with low unemployment had relatively high inflation rates.

For this trade-off to have relevance, two factors should be present. The first is that the rate of participation in the labor force must be constant, while the second is that the relative importance of the factors of production should remain the same. As you know, neither has been the case in the United States. Most of the inflationary forces of recent years, such as energy, food and interest rates were not particularly related to changes in employment and unemployment. Even more important is the fact that the labor force participation rate (total labor force as a percent of the noninstitutional population) has not held steady but has increased dramatically. This has caused the jobless rate many times to reflect more people looking for work, rather than just fewer jobs alone.

It wasn't always this way. During the first 20 years of the postwar era, labor force growth roughly paralleled the increase in the population. In other words—the rate of entry into the labor force by people as they turned working age was constant, and, once they reached a certain age level and had not decided to look for work, they remained out of the labor market. In this environment, it was appropriate to place great emphasis on the

CHART II
UNEMPLOYMENT RATE, INVERTED SCALE (LINE)
VS. INFLATION RATE (DOT)
(PERCENT)

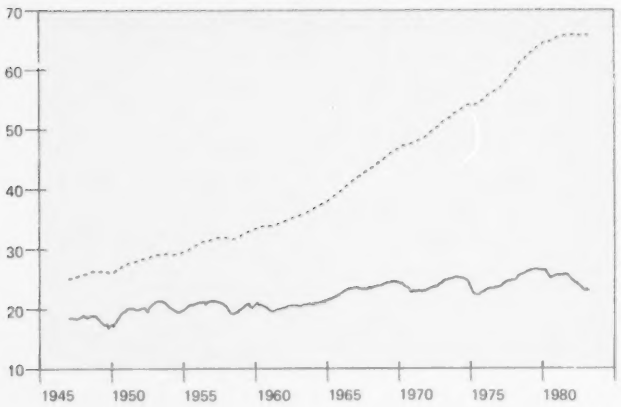


unemployment rate both as a reliable indicator of the condition of the labor market and (in an inverse way) as a good measure of inflation pressures.

Since the mid 1960s attitudes toward job holding have changed. I guess it started around the time the Vietnam

War escalated, causing large numbers of males to be drafted into the military. As was the case during World War II, their positions in the civilian labor force were filled, at least in part, by women, many of whom found themselves working for the first time. The rise of the Women's Liberation movement further encouraged women to remain in the work force as a means of showing their "independence." Other factors that contributed to an increased incidence of women working included a rising divorce rate and, in the late 1970s, the spiraling rate of inflation. The ending of the draft following the ending of the war allowed large numbers of teenagers to seek work, rather than stay in school.

CHART III
GOODS-PRODUCING EMPLOYMENT (LINE)
VS. SERVICE-PRODUCING EMPLOYMENT (DOT)
(THOUSANDS)



The net result is that the one-income family has become a thing of the past. The average family now has at least two people working, and, in some instances, three. Reflecting a jump in the female participation rate to 52½ percent last year from 39 percent in 1964 and 32 percent in 1947, the overall labor force participation rate reached 64 percent in 1982. In 1964 it was 58.7 percent—little different from the 58.3 percent of 1947. The participation rate of males in the labor force has declined somewhat over the years. In 1947 86½ percent of males were in the work force compared with 81 percent by 1964 and 76½ percent last year (see Table I). Some of this might trace to the increased incidence of females in the work force as some males have elected to stay home and let their wives work. However, some undoubtedly traces to the changed structure of the economy; jobs that are more likely to be filled by males (those requiring physical labor) have been eliminated due to a variety of factors including automation, foreign competition or, simply, a decline in the need for the products produced by certain industries.

A good example is the manufacturing sector. While manufacturing occupies about the same share of the real economy today as it did more than 30 years ago (some 24 percent), the percentage of employment in the manufacturing sector has dropped dramatically. In 1950 manufacturing could claim about one-third of all those employed; today it accounts for little more than one-fifth. The goods producing sector in general has seen its share of employment fall from 41 percent in 1950 to 26 percent today. By contrast, industries considered to be service producing have seen their share of employment rise from 59 percent in 1950 to 74 percent today. Services in particular about doubled their share from 11.9 percent in 1950 to nearly 22 percent in 1982 (see Table II).

A glance at the payroll employment statistics shows that, if anything, these trends accelerated during the past recession. Total nonagricultural payroll employment today is some 2½ million below its peak of July, 1981. Within this category, goods producing

TABLE II

SHARE OF REAL GROSS NATIONAL PRODUCT AND EMPLOYMENT BY SELECTED CATEGORIES 1950 TO DATE

	1950	1960	1970	1980	Latest Data*
TOTAL	100.0%	100.0%	100.0%	100.0%	100.0%
GOODS PRODUCING					
% of GNP	37.5%	35.7%	33.9%	31.6%	31.7%
% of Employment	41.0	37.7	33.3	28.4	26.0
of which:					
Manufacturing					
% of GNP	24.5	23.3	24.1	23.8	23.9
% of Employment	33.7	31.0	27.3	22.4	20.5
of which:					
Durables					
% of GNP	14.6	13.7	14.3	14.2	14.3
% of Employment	17.9	17.5	15.8	13.5	11.9
Nondurables					
% of GNP	9.9	9.6	9.8	9.6	9.6
% of Employment	15.8	13.5	11.5	9.0	8.6
SERVICE PRODUCING					
% of GNP	61.3	63.6	65.1	67.0	67.3
% of Employment	59.0	62.3	66.7	71.6	74.0
of which:					
Services					
% of GNP	11.1	11.3	11.7	12.8	13.1
% of Employment	11.9	13.6	16.3	19.8	21.7
Wholesale & Retail Trade					
% of GNP	16.4	15.9	16.2	16.5	16.7
% of Employment	20.8	21.0	21.2	22.5	23.0
Governments (All Levels)					
% of GNP	14.1	14.6	14.1	12.0	11.9
% of Employment	13.3	15.4	17.7	18.0	17.7

*Latest data for employment is first-quarter 1983, for GNP, 1981
Sources: Bureau of Economic Analysis; Bureau of Labor Statistics; MHT

employment, which today accounts for about one-fourth of all nonagricultural payroll employment, caused all of the decline since July 1981 and then some. By contrast, service-producing employment increased by about 150,000 (Chart III). The manufacturing sector alone saw its payrolls shrink by over 2.1 million while service industries increased their payrolls by 678,000.

...Nor Continued Recession

What all of this means is that, in looking at the labor force figures, one should look at the doughnut as well as the hole: employment besides unemployment. If one does, one will find as a top-line conclusion that the number of jobs has not shrunk much during the past recession, thus the ability of the population at large to support itself is no worse than the postwar average—notwithstanding the unusually high rate of unemployment. Within the employment totals, however, there are changes which reflect the shifts in the economy that are apparently taking place away from manufacturing in particular (and goods producing in general) to service producing industries. While this is causing some people to face a permanent loss of jobs unless they learn new skills, it is providing openings for others who are more interested in working nowadays than their older siblings or parents might have been some years ago.

There does not seem to be a quantitative trade-off between inflation and unemployment. Indeed, if there is a relationship between the two, it is not negative, but positive: The spiraling inflation of the late 1970s caused second and third workers from households to enter the labor force seeking work to help the breadwinner make ends meet. While the reduction in inflation could, by this line of reasoning, enable some of these newcomers to withdraw from the labor force thus allowing the unemployment rate to more accurately reflect the creation of jobs, the extremely long period of time during which the U.S. has been in an economic slump, combined with the 40 year-high rate of unemployment, might very well encourage these secondary workers to remain in the labor force if they believe that jobs will be more plentiful, in order to help their own households recover. If this were to happen, the unemployment rate would stay high well into the economic recovery.

This is why I would place greater emphasis on the employment numbers, both as a means of analyzing the state of the economy as well as for policy recommendations. What I am referring to, of course, is the effects that employment seems to have on inflation. While factors of production do change, the employment/population ratio is a good measure of the degree to which the economy is being stretched to its limits or not as the case may be. Therefore, policymakers should watch this measure very closely as they attempt to reduce unemployment.

Right now, because of the sharp drop in the employment rate, there does not seem to be much danger of inflation accelerating—trends in money growth notwithstanding. However, once the employment rate turns up, the time will draw near to keep a watch for inflation. M

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
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MAY 1983

Current Issues

Over the next few weeks, policymakers here and abroad will be grappling with a number of economic issues. How these are resolved will have significant bearing—not only on the outlook for the near-term, but, conceivably, for many years into the future as well. At present, there is the question of the Federal government's budget, and how much red ink it will run. At the end of this month, there is the meeting of the principal industrial nations of the Free World in which a wide variety of international and domestic items will be discussed, among them, foreign exchange rates. And in July, the House of Representatives Committee on Banking, Finance and Urban Affairs plans to hold hearings reviewing the five-year record of monetary policy under the Humphrey-Hawkins Act. What follows is a brief discussion of these agenda items, which, I hope, will help the reader put them in proper perspective.

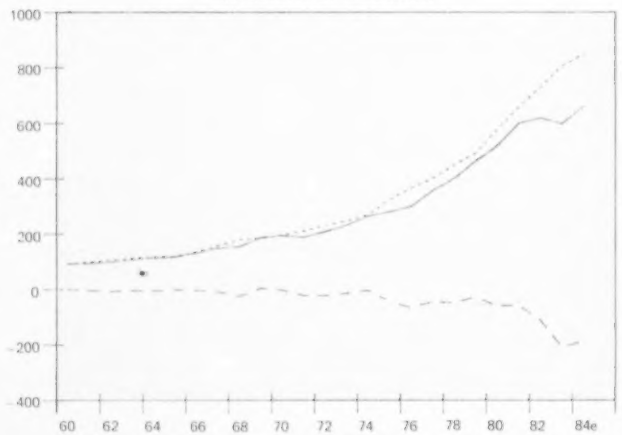
The Deficit Question

The inability of Congress and the Administration to agree on a budget resolution reflects more than differences over spending priorities. A country as big as ours, with so many regional interests, is bound to have differences of opinion, when it comes to dividing up the Federal budget. In the past these differences were resolved—although not without sizable growth in government spending. The political process being what it is, in most years of the postwar era the Congress failed to vote enough revenues to match these expenditures, so the budget tended to be in the red.

As readers of this Report know by now, I am no fan of budget deficits. Yet, the economy managed to grow and prosper throughout the postwar era even though Washington ran about four budget deficits for every budget surplus. This is because these deficits were relatively small, compared with the size of the economy, the financial markets, savings, and so forth.

All this changed starting in 1981. It was then that the Economic Recovery Tax Act (ERTA) was passed. It called for an across-the-board reduction in individual income tax rates and other reductions in individual income taxes; the annual adjustment of the zero bracket amount, the personal exemption, and individual income tax brackets for inflation beginning in 1985; and the accelerated cost recovery of capital expenditures. Although this was passed at a time when the budget was in deep deficit (the fiscal year 1980 deficit of $59.6 billion was less than $7 billion shy of the all-time record set in 1976, while FY81's deficit amounted to $58 billion), it was sold to the Congress and the American people on

FEDERAL BUDGET RECEIPTS (LINE), OUTLAYS (DOT)
AND BUDGET SURPLUS OR DEFICIT (DASH)
(BILLIONS OF DOLLARS)



Sources: Department of the Treasury; Office of Management and Budget

the basis that it would generate more tax revenues by encouraging people to work harder, invest more and come out from the "underground" economy. As you can see from the chart, this did not work. There was a dramatic falloff in revenues starting in 1981, immediately upon passage of ERTA. And, as I have noted in the past, the Administration now admits that it will lose $609 billion from 1982 through 1986 as a result of ERTA.

What amazes me is that, in the face of these developments, the Administration has been able to shift the focus of public attention away from the revenue side toward the spending side—and that means the Congress. Now I am not going to say that government spending

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has not risen rapidly in recent years. Nor am I about to defend every item in the expenditure budget—nondefense or defense. However, I do think several points are worth mentioning. First, the notion that defense spending should be put on a par with nondefense spending by comparing it with GNP gives me a great deal of trouble. I cannot see where the size of our economy should have anything to do with the size of defense spending. How much money needs to be allocated to defense should be determined by such factors as world tensions, our military preparedness, as well as the state and cost of military technology. But the size of our economy *does* have something to do with the size of nondefense spending, since these are expenditures for goods and services that go largely to U.S. citizens.

There is no denying that there has been significant growth in nondefense spending over the past thirty years. It is also true that a lot of this growth has come since the 1970s, with the enactment of the so-called "entitlement" programs introduced or modified around the turn of that decade. In such programs, the basic legislation does not appropriate a fixed amount of money for a particular purpose, but establishes rules that define who is eligible for benefits and the nature and amount of benefits for which each person is eligible. Funds must subsequently be appropriated to pay for these benefits, and the tremendous buying power that these benefits represented has caused the cost of these programs to rise, and with it the necessity for more and more Federal money.

Those who complain that this is adding unnecessarily to the size of government might be right, but the way to go about reducing it is not to deprive government of revenues and then ask the Congress to respond by curtailing spending. As I have noted in the past, with only two budget surpluses in the past 25 years, when did lack of revenues ever constrain the government from spending? Rather, the whole question may have to be put to a national referendum. Since politicians find it very difficult to do anything that will jeopardize the support of their constituents, the time may have come to ask the electorate what its preferences are. Barring that, we might want to consider the words of the immortal Will Rogers, who once said: "We will never get anywhere with our finances, 'till we pass a law saying that every time we appropriate something, we got to pass another bill along with it stating where the money is coming from."

But this is for the future; for now, it is imperative that revenues be put back on track. The Administration, itself, admits that even under the best of circumstances the budget will still be in deficit by close to $200 billion in 1985 and nearly $150 billion in 1986. There is no way that these deficits will be able to be financed in the context of continued recovery of the private sector, low interest rates and low rates of inflation. So if this recovery is to last beyond 1984, Washington's budget deficits must be shrunk as soon as possible. Government spending ought to be curtailed, to be sure—but government revenues must be restored in the meantime.

Floating Exchange Rates

Toward the end of last year, at a meeting originally scheduled to deal with an increase in lending power for the International Monetary Fund, the U.S. suggested that the agenda also include a discussion of the much broader issue of changes in the world's monetary system. Specific reference was made to foreign exchange rates, which besides being volatile, have resulted in currencies not being valued at appropriate levels relative to one another. The dollar is a good example, since most economists believe it is overvalued against the currencies of our trading partners. In turn, this has had a significant impact on the U.S. economy by curbing our exports and encouraging imports. One way to measure this is to compare the change in net exports (exports minus imports) over the past six calendar quarters with the change in the gross national product, both adjusted for inflation. Looked at this way, net exports, which amounted to only two percent of the real GNP during this time, accounted for about 70 percent of its decline!

The ten-year old floating exchange rate system has had its boosters and detractors over the years. It is generally agreed that no system of fixed exchange rates could have survived the significant jumps in oil prices of the 1970s, their effect on inflation, currency flows and world trade. And since speculators no longer had fixed currency targets to shoot at, monetary crises, such as were common in the closing days of fixed exchange rates, have largely been avoided. However, in their place has appeared day-to-day currency volatility, spawning persistent distortions in exchange rates, generating a mood of uncertainty that may have injured world trade and added a premium onto interest rates everywhere. As Paul Volcker, Chairman of the Federal Reserve System, recently said: "While some or most of the major swings (in exchange rates) have had a rationale in terms of divergencies in inflation rates, competitive positions, or structural changes, the extent and timing of some of the changes have, even in retrospect, been difficult to explain." While suggesting that intervention by central banks is a limited tool that cannot by itself alter market forces, Chairman Volcker was hopeful of being able to dampen extreme exchange rate movements, saying: "We can constructively do something to help stabilize exchange rates within the general framework of the floating system."

As I see it, several questions must be addressed, in order for this discussion to be meaningful. The first is: Are we talking about only dampening daily and weekly movements of currencies against one another, or will there be other objectives, such as attempting to move the value of currencies in a direction which may seem

economically prudent but against what the markets judge should be the case? Will these exchange rate objectives be announced in advance? How long and how serious a commitment will there be? And last, but by no means least, will attempts to harmonize exchange rates be accompanied by harmonious economic policies?

Your guess is as good as mine as to how the first three questions will be answered, but one point seems germane at this time. This is a widespread belief that, for the first time in recent memory, the major industrial countries of the West now have the same economic objectives, thus raising the possibility that their economic policies *can* be coordinated. All of us are either in or just emerging from severe economic recession. At the same time, interest rates are still too high, so another mutual objective would seem to be to reduce the cost of money. And while no country should ever let down its guard completely against the possibility of renewed inflation, the facts are that the U.S. and most of its trading partners have made dramatic progress in slowing the rate of inflation over the past few years.

Since the current economic environment dictates that the U.S. and its major trading partners should now favor fighting unemployment and restoring economic growth, if we are to ever take a stab at reducing exchange rate volatility, now might be the most appropriate time. However, intervention cannot take the place of economic policy coordination as a means of *fundamentally* dampening swings in currency values. And needless to say, economic policy coordination requires just that: An agreement on the part of the Free World's trading partners to pursue similar domestic policies—in this instance, designed to keep inflation under control while stimulating economic growth. I know it is asking a lot for nations to give up some degree of economic sovereignty in order to create a more viable international monetary system. But like the discussion regarding the Federal budget, there must be compromise; not everyone can have his way.

Monetary Policy

Although the economy is clearly on the upswing and this year is *not* an election year, the Congress, nevertheless, intends to take a very close look at monetary policy this summer. There are several reasons for this. For one thing, the four-year term of Federal Reserve Chairman Paul Volcker expires in August and, as you might imagine, there is much interest on the Potomac in who his successor might be—if there is one. Second, although interest rates have come down substantially from their year-ago peaks, they are still high, when compared with the rate of inflation, and when they are not blaming the banks for this (Economic Report—March, 1983), the politicians tend to blame the Fed. Finally, it 's been five years since Congress passed the Humphrey-Hawkins Act, which, among other things, required the Fed to report to the Congress its targets for monetary growth at semiannual "oversight" hearings.

Any examination of monetary policy should deal with several questions. For one thing, can the money supply be identified with sufficient precision to allow its use as an objective for Fed policy—not to mention as a proxy for economic performance? From here, it would seem that the answer is; "not as much as previously." This is because recent deposit innovations and financial deregulation have blurred the conception of "money." If the purpose of establishing a certain rate of growth for the money supply is to ensure that there is neither too much nor too little liquidity in the economy, then the Fed may be having a hard time determining just what is liquidity. This is because of the rise of money market mutual funds, money market accounts at commercial banks and thrifts, negotiable orders of withdrawal (NOW) and Super NOW accounts—along with a greater awareness and sophistication on the part of the public as to the availability of such forms of near-money as certificates of deposit, Treasury securities, and so forth. As a result, if there ever was a definable monetary aggregate with a stable relationship to GNP, inflation, and unemployment it is less apparent today.

Reference is also made to the velocity of money. This is the rate at which money changes hands, and is obtained after the fact by dividing the dollar value of the gross national product by the money supply. Trends in velocity have neither been stable nor predictable over short periods of time, but velocity has apparently been declining for a year and a half—the longest period in postwar economic history. The question that faces the Federal Reserve at this point is how much longer will this decline last, and what should be done once velocity increases. For the Fed had to pump out significant sums of money starting in the middle of last year in order to get interest rates down and the economy growing again. That money is still in circulation, and has the potential to produce a new round of inflation, if people should decide to spend it faster.

In the process of engineering the decline in interest rates in 1982, the Federal Reserve, besides pointing to the "breakdown" in velocity trends, had to convince the financial markets that the monetary aggregates were not as believable as before. The Fed managed to do this by pointing to such developments as the maturing All-Savers accounts, the new money market accounts that banks and thrifts were allowed to offer, and other factors. Whether or not these developments reduced the reliability of the monetary aggregates remains to be seen, but they do reveal that the Fed has been following an eclectic policy for almost a year, rather than one focusing strictly on the money supply or similar monetary variables. In my view, this was—and still is—the appropriate policy for the Fed to follow. Reliance on the monetary aggregates alone is useful mainly during periods when inflation is the Fed's primary target; it doesn't always follow that achieving

certain rates of growth in these aggregates (if it were possible) is correct during this stage of an economic recovery.

Another question likely to be on the Congressional agenda deals with the need to coordinate monetary and fiscal policies. These two policies went out of synchronization late in 1979, when the Fed moved to tighten money while the budget deficit was getting wider. The disparity became so big by midyear 1982 that a serious liquidity squeeze developed, causing the Fed to back down. Since the deficit is even larger today and is still growing, the focus in the Congress might be to ensure that monetary policy remains easy. If this is the case and the Congress succeeds in imposing its will on the Federal Reserve, then our long range prospects for inflation are not bright. There needs to be coordination between fiscal and monetary policy—but it is fiscal policy that must be changed, not monetary policy (see discussion of the budget above).

Given the levels that interest rates reached last year, the public's belief that the Fed is responsible for this, plus the fact that central banks in most other countries are under the domination of the politicians, it is going to take the best possible arguments that can be mustered by the Fed and its supporters in the financial markets to keep it independent. I can think of one right away: When central banks lost their independence in other countries, inflation worsened and business conditions deteriorated.

In the ideal world, of course, monetary and fiscal policy should be coordinated. But as readers of this Report undoubtedly have figured out by now, what is ideal in theory rarely works out in practice. As long as the real world remains imperfect, the Fed ought to remain independent, acting in the economic sphere the way the judiciary acts in the legal area—to safeguard our system. M

GOLF FANS' DREAM WEEK

WHAT:
The Manufacturers Hanover Westchester Classic

WHERE:
Westchester Country Club
Harrison, New York

WHEN:
Monday, June 6, thru Sunday, June 12
Monday: Practice Round, **Tuesday:** Practice Round, National Long Driving Championship and Junior Golf Day, **Wednesday:** Pro-Am, **Thursday:** First Round, **Friday:** Second Round, **Saturday:** Third Round, **Sunday:** Final Round

WHO:
Many of the top pros on the PGA TOUR—
including Bob Gilder, defending champion—competing for $450,000 in prize money. Winner's purse: $81,000

HOW:
Tickets are available at the gate, or to charge on Visa or MasterCard call 212-808-8100
Sports House and Grounds: $50 for all 7 days; $5 each day for Monday and Tuesday; $10 for Wednesday; $15 each day for Thursday, Friday, Saturday and Sunday
Grounds only: $40 for all 7 days; $3 each day for Monday and Tuesday; $6 for Wednesday; $12 each day for Thursday, Friday, Saturday and Sunday
Youngsters 14 and under, accompanied by an adult: $5 (at the gate only). On Tuesday, junior golfers 18 and under are admitted free.

WHY:
The opportunity to see championship golf and support the 13 Westchester hospitals that share in the proceeds

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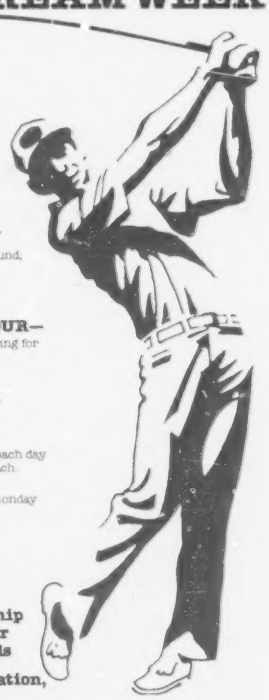

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

JUNE 1983

Business Conditions Update

By now, it should be fairly clear that the U.S. economy has entered the expansion phase of the business cycle. It seems also safe to say that, while this recovery will not go down in history as one of the strongest, neither will it be the weakest. The upswing has enough going for it to propel business activity forward through the end of this year and well into 1984.

Evidence that the economy is on the mend is abundant. The Federal Reserve's index of industrial production, the single most accurate and important barometer of business recessions and expansions, is up about seven percent since last November. As a result, total employment in the U.S. has jumped by 900,000 since the end of last year and the jobless rate has fallen by 0.7 percentage point. With more people working, more incomes are being earned. The rise in personal incomes from March through May was the biggest three-month increase since summer, 1981. More incomes mean more spending. Automobile sales are running 50 percent above year-ago levels while new-home sales are 60 percent higher. Retail sales have jumped by nearly 6½ percent in the past three months—most of which is "real", since price inflation at the retail level remains very low.

Further gains would seem to be in store. Incomes will get another shot in the arm July 1, when personal income taxes are reduced by $35 billion. The combination of low rates of inflation, steadily falling unemployment—and a booming stock market—has evidently brightened consumer confidence. Various surveys of consumer attitudes show a distinct improvement compared with six months ago.

Notwithstanding the jump in industrial output, the level of business inventories has fallen as assembly lines were not speeded up in line with incoming orders. Over the past year business inventories have fallen nearly four percent, with the key manufacturing sector reporting a drop nearly twice as much. As a consequence, inventory-sales ratios have descended from their highs of 1982. In many lines of business, inventories are the thinnest they have been in several years.

These factors alone would seem to suggest that the recovery is building upon itself. The combination of rising sales and orders and falling inventories represents a powerful temptation to restock. Some will rebuild, but many other industries will simply aim to halt the runoff in inventories, neither liquidating or accumulating. This would be quite a change from the normal inventory cycle at this point in a business expansion.

A Modest Inventory Buildup . . .

There are several good reasons why inventories will not be rebuilt as quickly as they were in the past. For one thing, interest rates remain historically high, both in nominal or quoted terms, as well as after factoring out inflation. Because this is a relatively new phenomenon, high real interest rates have become a deterrent to spending and borrowing and an inducement to saving and investment.

Another reason for going slow regarding inventory investment seems to be the generous degree of capacity available both here and abroad. Low rates of capacity utilization clearly indicate that suppliers have the ability to provide needed goods with a minimum of waiting. This goes for the United States, as well as for our major trading partners, whose economies, as you know, have been depressed as well. The continued strong dollar makes imported merchandise even more tempting as a source of refilling pipelines.

NO REPORTS IN SUMMER

The monthly Economic Report will not be published during July and August. The next issue will appear in September.

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The inventory cycle will also be affected by recent inflation trends. In the past, with inflation escalating through each business cycle, memories of rapidly rising prices were still clear and businessmen sought to replenish their stocks sooner, rather than later, in order to avoid paying higher prices. This time, however, the attitude is just the opposite—not surprising, in view of the degree to which the rate of inflation has moderated.

There are other deterrents to inventory building, too. Weak balance sheets are causing many companies to try to reduce their level of indebtedness as their sales and order prospects improve. Rather than building inventories, they are utilizing improved cash flow to pay off debt. Those companies that have access to the bond markets are borrowing long-term money and using it to pay off short-term debt. The stock market is being utilized in a similar fashion. Even if the rate of bond and stock financing in evidence during the first four months of this year continues through yearend, corporate balance sheets (the ratio of short-term to total liabilities) in the aggregate will do no more than return to their condition at the end of 1980.

. . . Plus Cautious Money Management . . .

Finally, there is a degree of caution that can only come as a legacy from a recession that by many accounts was the worst in the postwar era and a recovery preceding it that was the shortest in 60 years. Not only are businessmen shell-shocked from the recession as well as from the apparent difficulty they are experiencing in raising prices some six months into recovery, but they are concerned about the future, especially when they hear more and more economists talk about the concerns they have over the economic outlook.

Not that anyone thinks the recovery will not make it through year-end 1983. The consensus of economic forecasters is firmly united on this point. Indeed, one would have to look very hard to find a forecaster anticipating a downturn in 1984. Most economists are leaning toward even faster rates of growth in 1984 than in 1983. It's just that, in analyzing the outlook, so many economists tend to couch the good news with caution.

To be sure, there is no shortage of things to be concerned about. Looking at the near term, the first item that comes to mind is excess money growth and financial market fears of higher interest rates as a by-product. Since the beginning of the year, the widely-watched money supply M1 has jumped by nearly $32 billion, when adjusted for seasonal variation. This has placed its year-to-date growth about $14 billion above the Federal Reserve's upper target boundary, raising the specter of higher interest rates because of either a tightening of the money and credit reins some time soon, or because of the flare-up in inflation that would result if this growth were left unchecked.

However, while the seasonally adjusted money numbers have been soaring, the actual money supply has been declining. Since the turn of the year, the unadjusted M1 has actually fallen by over $6 billion. The money supply usually falls during the first half of the year, but apparently the decline in first-half 1983 was not very large. It is difficult to say what the trend ought to be for this variable in view of the changes it has undergone in recent years, what with the development of new savings and checking accounts, money definitions and the like.

Needless to say, the markets are the ones that matter and if they are keeping interest rates high because of concern over money growth, then whether the actual money supply is rising rapidly or not becomes almost irrelevant. As long as interest rates remain where they are, it is possible that such credit-sensitive sectors of the economy as autos and housing will not be able to improve their performance much more. And both industries' sales are not much higher than levels first reached at the end of 1982.

If this were not enough, economists are concerned over the export sector. Not only are we exporting less and importing more, but barriers to the free flow of world trade appear to be popping up as fast as weeds in a summer garden. As I pointed out last month, net exports exerted a disproportionate effect on the economy between summer 1981 and spring 1983, accounting for nearly 70 percent of the drop in the real GNP. Continuing on the international scene, there are worries about the ability of many developing countries to continue to absorb U.S. exports in light of their well-publicized liquidity difficulties, not to mention service their external debt, as well as whether oil prices will take another giant step downward thereby exacerbating other countries' debt burdens.

June, 1983
MHT FORECAST OF GROSS NATIONAL PRODUCT
(Seasonally Adjusted Annual Rates)
In $ Billions

	< Actual						Projected >					
	1982				YEAR 1982		1983				YEAR 1983	
	I	II	III	IV	LEVEL	% CH	I	II	III	IV	LEVEL	% CH
Gross National Product	2995.5	3045.2	3088.2	3108.2	**3059.3**	**4.1**	3170.9	3261.0	3330.6	3407.4	**3292.5**	**7.6**
GNP: $72	1470.7	1478.4	1481.1	1477.2	**1476.8**	**−1.7**	1486.2	1511.6	1530.6	1548.3	**1519.2**	**2.9**
% Change, Annual Rates	−5.1	2.1	0.7	−1.0	**−1.7**		2.5	7.0	5.1	4.7	**2.9**	
Consumption	1919.4	1947.8	1986.3	2030.8	**1971.1**	**6.9**	2054.2	2100.8	2145.3	2192.6	**2123.2**	**7.7**
Durables	237.9	240.7	240.3	251.8	**242.7**	**3.5**	257.3	267.3	277.2	289.5	**272.8**	**12.4**
Non-Durables	749.1	755.0	768.4	775.7	**762.1**	**3.7**	776.8	788.7	802.5	814.2	**795.6**	**4.4**
Services	932.4	952.1	977.6	1003.3	**966.3**	**10.6**	1020.0	1044.8	1065.7	1088.9	**1054.9**	**9.2**
Investment	414.8	431.5	443.3	391.5	**420.3**	**−10.9**	421.3	468.2	482.2	500.9	**468.1**	**11.4**
Non-Residential	357.0	352.2	344.2	338.4	**348.0**	**0.5**	338.1	339.3	342.5	349.4	**342.3**	**−1.6**
Producers Durable Equipment	215.6	208.6	203.0	198.8	**206.5**	**−4.6**	200.7	203.4	206.9	211.2	**205.5**	**−0.5**
Structures	141.4	143.6	141.3	139.6	**141.5**	**9.0**	137.4	135.8	135.6	138.2	**136.8**	**−3.3**
Residential	93.4	95.5	94.3	101.4	**96.2**	**−8.4**	120.5	131.4	140.5	141.9	**133.6**	**39.0**
Inventory Changes	−35.6	−16.2	4.7	−48.3	**−23.9**		−37.3	−2.5	−0.8	9.6	**−7.8**	
Net Exports	31.3	34.9	6.9	9.1	**20.6**		19.0	12.8	4.2	−0.4	**8.9**	
Government Purchases	630.1	630.9	651.7	676.8	**647.4**	**8.4**	676.4	679.2	698.9	714.3	**692.2**	**6.9**
Federal Defense	166.2	176.2	182.7	189.3	**178.6**	**16.2**	192.9	201.4	209.3	215.7	**204.8**	**14.7**
Federal Civilian	83.5	68.2	76.3	89.4	**79.4**	**5.5**	81.1	71.2	77.2	81.2	**77.7**	**−2.1**
State & Local	380.4	386.6	392.7	398.0	**389.4**	**5.8**	402.5	406.6	412.4	417.4	**409.7**	**5.2**
Final Sales: $72	1486.1	1482.7	1477.8	1497.5	**1486.0**	**−0.5**	1502.3	1512.8	1531.0	1544.3	**1522.6**	**2.5**
% Change, Annual Rates	0.2	−0.9	−1.3	5.4	**−0.5**		1.3	2.8	4.9	3.5	**2.5**	
GNP Price Index (1972 = 100)	203.7	206.0	208.5	210.4	**207.1**	**5.9**	213.4	215.7	217.6	220.1	**216.7**	**4.6**
% Change, Annual Rates	4.3	4.6	5.0	3.7	**5.9**		5.7	4.5	3.5	4.6	**4.6**	
PCE Deflator (1972 = 100)	202.2	204.0	207.7	210.0	**206.0**	**5.9**	211.1	213.6	215.8	218.1	**214.6**	**4.2**
% Change, Annual Rates	4.9	3.6	7.5	4.5	**5.9**		2.1	4.8	4.2	4.3	**4.2**	
Consumer Price Index (1967 = 100)	283.3	287.0	292.4	293.8	**289.1**	**6.2**	293.5	296.7	300.2	303.7	**298.5**	**3.3**
% Change, Annual Rates	3.0	5.3	7.8	2.0	**6.2**		−0.4	4.4	4.8	4.8	**3.3**	
Total Personal Income	2510.4	2552.5	2592.4	2624.0	**2569.8**	**6.4**	2648.3	2706.3	2760.2	2821.6	**2734.1**	**6.4**
Disposable Personal Income	2117.1	2151.5	2198.1	2224.3	**2172.8**	**7.1**	2247.2	2302.0	2365.3	2417.6	**2333.0**	**7.4**
Savings Rate	6.6	6.7	6.9	6.0	**6.5**		5.9	6.0	6.6	6.6	**6.3**	
Employment Rate	56.6	56.4	56.2	55.8	**56.2**		55.6	56.1	56.5	56.7	**56.2**	
Unemployment Rate	8.8	9.4	10.0	10.7	**9.7**		10.4	10.0	9.7	9.5	**9.9**	
Indus. Production (1967 = 100)	141.8	139.4	138.2	135.3	**138.6**	**−8.1**	138.4	143.8	146.5	148.9	**144.4**	**4.1**
Housing Starts (000)	902.7	949.7	1121.7	1261.0	**1058.8**	**−3.7**	1701.7	1560.7	1605.1	1628.0	**1623.9**	**53.4**
Domestic Auto Sales (000)	5733.3	5466.7	5504.3	6133.3	**5709.4**	**−8.2**	6000.0	6511.1	6853.3	7382.0	**6686.6**	**17.1**
Corporate Pre-Tax Profits	171.6	171.7	180.3	175.9	**174.9**	**−24.6**	178.3	196.3	206.7	215.1	**199.1**	**13.9**
− Taxes	56.7	55.3	60.9	58.0	**57.7**		65.7	69.6	70.3	73.0	**69.6**	
Net Profits	115.0	116.3	119.4	117.9	**117.2**	**−22.4**	112.5	126.7	136.5	142.2	**129.5**	**10.5**
− Dividend Payments	68.8	69.3	70.5	72.4	**70.3**	**7.9**	73.5	73.8	75.6	77.6	**75.1**	**7.0**
Undistributed Profits	46.1	47.0	48.8	45.5	**46.8**	**−45.4**	39.0	52.9	60.8	64.6	**54.3**	**15.9**
+ Depreciation	208.8	216.5	223.7	231.9	**220.2**		239.9	248.1	256.2	264.0	**252.1**	
− Inventory Profits	4.4	9.4	10.3	12.6	**9.2**		0.7	1.7	5.2	7.0	**3.6**	
Net Cash Flow	250.5	254.1	262.2	264.8	**257.9**	**2.9**	278.2	299.3	311.9	321.5	**302.7**	**17.4**

Sometime in 1984, we will have to face the prospect for a clash between Washington's financial needs and those of the private sector. As long as the budget deficit remains large, Washington will be a major factor in the credit markets. This year, Washington's financing needs can be met in the context of stable to declining interest rates because of the accommodative posture undertaken by the Federal Reserve as well as because of the reduced short-term credit needs by the private sector.

But this combination will not last indefinitely. For one thing, the Fed cannot remain accommodative for too long—regardless of the degree to which the seasonal adjustment factors may be distorting money growth. As for the private sector, there will come a point in 1984 when it will make less and less financial sense for businessmen to borrow long-term to finance short-term needs—especially if long-term interest rates remain well above rates available on short-term loans. Thus it could very well be that the demand for short-term funds by the private sector will increase at the very moment that the Federal Reserve becomes less generous. With Washington continuing to raise huge sums of funds in the money markets to finance its mega-deficits, this would seem to be a recipe for sharply rising interest rates. And high interest rates, as we have clearly seen, are, in turn, a recipe for recession.

. . . Might Produce a Healthy Recovery

One cannot blame businessmen for being cautious over the economic outlook. But this very caution may keep the economy expanding longer than some expect. For it will keep a lid on wages and prices and turn businessmen (and consumers) into better managers. This is bound to improve efficiency, making us more competitive with products produced abroad. At the same time, better cash management might delay the clash between the private sector and the public sector, allowing the Federal Reserve to slow the growth rate of money without precipitating a hike in interest rates. Needless to say, the longer the economy recovers, the more tax revenues will be generated and the less Washington's budget deficit will be. Lower unemployment and a slow rate of inflation will help the spending side of the budget.

In other words—fears of a weak and short-lived recovery could well contribute to turning this expansion into one of the healthiest ones in postwar economic history. We just might be on the track to sustained economic growth with moderate rates of inflation. H

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The Manufacturers Hanover
Economic Report

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How Bad Was It?

During the summer, the National Bureau of Economic Research, the nation's unofficial arbiter of the business cycle, declared that the recession which began two years earlier came to an end last November. Although this decision was made some seven months after the fact, it nonetheless has significant bearing for current and prospective economic and political developments. This is because it permits a comparison to be drawn between the latest recession and prior postwar declines in economic activity. In previous Economic Reports, I have discussed what I believe were the causes of the 1981-82 recession, thus I will not repeat them here. However, I do think it is useful to compare this past recession with its predecessors to see if any lessons can be learned.

The 81-82 Recession ...

The first measurement that comes to mind, of course, is length. Affixing November 1982 as the terminal date means that the 1981-82 recession was 16 months in duration. This equals the 1973-75 recession as the longest in the postwar era. Together, these two recessions were longer than any continuous decline in business activity since the 43 month slump that marked the first phase of the Great Depression (August 1929-March 1933). Naturally, the most recent recession was longer than average. The seven previous postwar declines averaged ten months in length.

Another way that recessions can be compared is in terms of depth. Two important ways of looking at this are the percentage decline in the real gross national product and in industrial production. Looked at this way, a slightly different conclusion emerges. To be sure, the 1981-82 recession comes in worse than average in terms of percentage drop in the economy. The real gross national product fell by three percent during this time compared with the average for the previous seven recessions of 2½ percent. The same is true for industrial production. From top to bottom industrial production fell by 12.3 percent in the most recent recession compared with an average decline of 10.3 percent for the previous seven cycles.

However, in neither case was the decline the worst or even tied for the worst in the postwar era. In the case of the real gross national product, the title goes to the recession that began in November 1973 and ended in March 1975. In that recession the real GNP fell by 4.9 percent—far and away the biggest drop in the postwar era. There were two other recessions whose decline in the real gross national product exceeded the one registered in 1981-82. The 1957-58 recession saw real GNP fall by 3.3 percent, while the recession of July 1953 to May 1954 registered a 3.2 percent decline in real GNP.

Looking at industrial production, one finds that the biggest drop also occurred during the 1973-75 recession. Then, output of the nation's factories, mines and utilities fell by 15.3 percent. The second biggest postwar decline in industrial production occurred during the recession of 1957-58. Although one of the shortest (eight months in duration) of the postwar era, it clearly was one of the most severe, with industrial production plunging by 13.5 percent.

Both labor and management would argue that the most recent recession was the worst in half a century. The unemployment rate, as is widely known by now, touched a postwar high of 10.8 percent in the last recession—more than three percentage points higher than the average peak jobless rate of the previous seven cycles. Employment, correspondingly, registered a greater percentage decline during the most recent recession than it did on average during the previous downturns, with manufacturing payrolls, especially in durable goods industries, suffering relatively more than other sectors.

Interestingly, the percentage increase in the number of people unemployed, 53.2 percent, was far below average and one of the smallest in the postwar era. How-

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ever, this measurement, like so many others, may have been affected by the fact that the 1981-82 recession followed almost immediately on the heels of another recession, a six month downturn occurring during the first half of 1980. The 12 months that separated the January 1980-July 1980 recession from the July 1981-November 1982 recession was the shortest in postwar history. Indeed, it was the shortest in 60 years! By the same token, the six-month recession that the NBER says occurred during first-half 1980 was the shortest of all the officially recognized recessions going back to the early 1850s. This has led many economists to conclude that the 1980 and 1981-82 recessions ought to be considered together. If so, it would produce a downturn that in many—but not all—respects would represent the worst economic decline in the United States since the Depression.

... Was One Of The Worst ...

Two measurements important to business paint an equally as gloomy picture of the most recent recession. Corporate profits normally take it on the chin during an economic decline, but this time the blow was much harder than usual. On average, corporate profits fell about 22 percent during postwar recessions. Until the latest, the biggest percentage decline in corporate profits occurred during the 1957-58 recession, when pretax earnings fell by 27 percent. The 1981-82 recession, however, saw profits plunge by more than 31 percent. And, since many businesses did not fully recover from the 1980 recession, when profits fell by 18 percent, you can see that the business sector was really hit hard. Some companies were hit so hard that they were knocked out of contention all together. Business failures during the most recent recession reached their highest levels since the depths of the Great Depression some 50 years earlier.

Another measurement deals with pervasiveness, or how many industries were affected by the decline in aggregate economic activity. As you can see from the table, the percentage of industries with falling output during a recession is normally quite large, averaging about 90 percent. But the 1981-82 recession was the first of the postwar downturns when all of the two dozen major industries regularly monitored by the NBER reported falling output.

Looking beneath the surface produces even more diverse results. For example, while output of consumer goods did fall by more than it did on average, this traced to a greater than usual decline in consumer softgoods output, rather than consumer hardgoods production. Indeed, the 15.8 percent drop in production of consumer durable goods was not only less than the 19.9 percent average decline, it was the smallest percentage decline since the recession of 1948-49. By contrast, the 1973-75 recession saw consumer durable goods output fall by nearly 30 percent. Coming in the wake of the quadrupling of world oil prices and the announcement of an embargo of Persian Gulf petroleum shipments to the United States, this was a product of long lines at gasoline stations—and a sharp decline in the demand for domestically-produced automobiles, most of which averaged less than ten miles per gallon. However, during the most recent recession, oil supplies were plentiful and their prices were declining. In addition, output of consumer durable goods had already fallen nearly 22 percent during the 1980 recession, so the level from which they began their plunge during the 1981-82 recession was obviously low to begin with.

DURATION, DEPTH AND DIFFUSION OF POST-WORLD WAR II RECESSIONS

Cycle Peak Trough	Duration In Months	Depth: Decline in Real GNP	Depth: Decline in Industrial Production	Depth: Peak Jobless Rate	Depth: Decline in Pre-Tax Profits	Depth: Lowest Operating Rate	Diffusion Index* Industrial Production
Nov 48–Oct 49	11	–1.5%	–10.1%	7.9%	–24.0%	71.7%	91.7%
Jul 53–May 54	10	–3.2	– 9.4	6.1	–23.6	78.8	87.5
Aug 57–Apr 58	8	–3.3	–13.5	7.5	–27.0	71.3	97.9
Apr 60–Feb 61	10	–1.2	– 8.6	7.1	–18.4	73.5	91.7
Dec 69–Nov 70	11	- 1.0	– 6.8	6.1	–19.8	75.9	79.2
Nov 73–Mar 75	16	–4.9	–15.3	9.0	–23.9	69.0	95.8
Jan 80–Jul 80	6	–2.3	– 8.6	7.8	–17.9	75.5	87.5
Average	10	–2.5	–10.3	7.4	–22.1	73.7	90.2
Jul 81–Nov 82	**16**	**–3.0**	**–12.3**	**10.8**	**–31.3**	**68.8**	**100.0**

*Maximum percentage of 24 industries with falling output over a six-month span.

Sources: National Bureau of Economic Research, Federal Reserve Board, Bureau of Labor Statistics, Commerce Department.

On the other hand, the drop in output of business equipment during the most recent recession was not only twice as great as average, it was equal to the worst decline in the postwar era. This can be traced to several factors. One is that capacity utilization fell to a lower point in the most recent recession than it did in any other previous postwar downturn. With nearly one-third of usable capacity lying idle, there clearly was little need for new equipment except for modernization.

Another major reason for the slump in purchases of business equipment deals with interest rates. Readers of these Economic Reports will recall that in 1980 and again in 1981 the cost of borrowing money reached astronomical levels—especially after adjusting for inflation. This made it very expensive to finance the purchase of a new machine, assembly line, factory, etc. The high level of interest rates also prompted many companies to invest in financial instruments rather than in their own business, since the rate of return was greater.

The heights to which both nominal and real interest rates reached during the most recent recession was something to behold. At 19.2 percent, the federal funds rate's peak level during the 1981-82 recession was about ten percentage points higher than the average peak funds rate of the five previous cycles. And that includes the 1980 recession, when funds topped 17 percent; excluding that cycle the 1981-82 funds rate peak was nearly 12 percentage points higher. The same can be said for the banks' prime lending rate with one important addition: at its low of 11¾ percent during the 1981-82 recession, the banks' prime lending rate was almost as high as the highest point reached during the 1973-75 recession, 12 percent.

The comparison of real interest rates is even more startling. During the six previous recessions, the real prime rate (the nominal prime rate minus the rate of inflation) averaged about two percentage points. Indeed, during both the 1973-75 recession and the 1980 recession the spread between the prime rate and the rate of inflation was negative—meaning that inflation was higher than the prime rate. In the most recent recession the real prime rate reached a peak of ten percentage points and only on two short occasions got as low as seven percentage points. As for long term rates, they also averaged about two percentage points during the six previous recessions, and turned negative during the two recessions immediately prior to the most recent one. In the most recent recession they, too, were several times higher than historical average. I might note that real long term rates are even higher today than they were during the last recession.

... But It Did Slow Inflation Markedly

Not all comparisons are negative. Indeed, the very severity of the 1981-82 recession produced one extremely favorable result: a marked reduction in the rate of inflation. Of course, recessions usually pull down the rate of inflation by reducing the ability of both business and labor to raise prices and wages owing to weak demands. But the extent to which inflation was curbed in the current recession is unprecedented in recent economic history. For example, the consumer price index was rising at a 12-month clip of close to 11 percent at the start of the last recession and at a year-over-year pace of only five percent 16 months later. What is more, inflation subsequently slowed to a 12-month rise of less than 2½ percent by June 1983—the smallest 12-month rise in 16 years. In fact, in the three months immediately following the end of the last recession consumer prices actually fell by an annual rate of 1.2 percent, the first three-month decline since 1954!

Thus inflation, which was running much higher than past experience as the U.S. entered the 1981-82 recession has now been brought back to rates of the 1960s. It may not be stable prices, but by the experience of the 1970s and the early part of this decade it sure feels a lot better. What is more, I do not detect a resurgence of inflation anytime soon—notwithstanding trends in the money supply and food commodities prices. This is because the still-high level of unemployment combined with the still-low rate of capacity utilization continues to keep pressure on wages and prices, making it difficult for both labor and management to ask for more. In their roles as consumers, people remain extremely reluctant to pay higher prices for anything—whether business goods or consumption items—and continue to go out of their way to patronize those who hold the line on prices, or offer discounts.

If we can keep this up, then the very severe recession just concluded will have left us with one positive legacy, and a very important one at that: a return to our historically low rate of inflation. ■

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